

personnel, and with developing systems to evaluate the information. Since it is unclear how many institutions will adopt these procedures, it is not possible to estimate the costs to institutions in general.

## V. Paperwork Reduction Act

In accordance with section 3507 of the Paperwork Reduction Act of 1980 (44 U.S.C. 35; 5 CFR 1320.13), there is no reporting or recordkeeping burden associated with Regulation B or this amendment.

## List of Subjects in 12 CFR Part 202

Aged, Banks, Banking, Civil rights, Consumer protection, Credit, Discrimination, Federal Reserve System, Marital status discrimination, Penalties, Religious discrimination, Reporting and recordkeeping requirements, Sex discrimination.

Certain conventions have been used to highlight the proposed revisions to the part. New language is shown inside bold-faced arrows, while language that would be removed is set off with bold-faced brackets.

For the reasons set forth in the preamble, the Board proposes to amend 12 CFR part 202 as set forth below:

## PART 202—EQUAL CREDIT OPPORTUNITY (REGULATION B)

1. The authority citation for part 202 continues to read as follows:

**Authority:** 15 U.S.C. 1691–1691f.

2. Section 202.5 is amended as follows:

- a. Redesignating paragraph (b)(3) as paragraph (b)(5);
- b. Adding a new paragraph (b)(3);
- c. Adding a new paragraph (b)(4);
- d. Revising paragraph (d)(3); and
- e. Removing paragraph (d)(5).

The revisions and addition read as follows:

### § 202.5 Rules concerning taking of applications.

\* \* \* \* \*

(b) \* \* \*

(3) *Permitted inquiries and collection of information.* A creditor may request applicants to provide their race, color, sex, religion, and national origin as part of the application. Applicants may not be required to supply the requested information. If an applicant chooses not to supply the information, the creditor may not note or otherwise record the race, color, sex, religion, and national origin of the applicant based on visual observation, surname or other means.

(4) *Residency and immigration status.* A creditor may inquire about an

applicant's permanent residency and immigration status.

(5) *fl* \* \* \*

\* \* \* \* \*

(d) \* \* \*

(3) *Sex.* [A creditor shall not inquire about the sex of an applicant.] An applicant may be requested to designate a title on an application form (such as Ms., Miss, Mr., or Mrs.) if the form discloses that the designation of a title is optional. An application form shall otherwise use only terms that are neutral as to sex.

\* \* \* \* \*

[(5) *Race, color, religion, national origin.* A creditor shall not inquire about the race, color, religion, or national origin of an applicant or any other person in connection with a credit transaction. A creditor may inquire about an applicant's permanent residency and immigration status.]

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, April 20, 1995.

**Jennifer J. Johnson,**

*Deputy Secretary of the Board.*

[FR Doc. 95–10230 Filed 4–25–95; 8:45am]

BILLING CODE 6210–01–P

## NATIONAL CREDIT UNION ADMINISTRATION

### 12 CFR Parts 704 and 741

### Corporate Credit Unions; Requirements for Insurance

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Proposed rule.

**SUMMARY:** The proposed rule would strengthen the capital of corporate credit unions, reduce the risk of their investments, and improve asset-liability management. It would return corporate credit unions to their primary functions of serving as liquidity centers and service providers and would protect the safety and soundness of the corporate credit union system.

**DATES:** Comments must be postmarked or posted on NCUA's electronic bulletin board by June 26, 1995.

**ADDRESSES:** Mail comments to Becky Baker, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314–3428. Send comments to Ms. Baker via the bulletin board by dialing 703–518–6480.

**FOR FURTHER INFORMATION CONTACT:** H. Allen Carver, Director, Office of Corporate Credit Unions (703) 518–6640, at the above address.

## SUPPLEMENTARY INFORMATION:

### A. Background

The corporate credit union system consists of 44 corporate credit unions serving the nation's 13,000 natural person credit unions, and U.S. Central Credit Union serving the corporate credit unions. Corporate credit unions provide liquidity, investment, and payment services to credit unions. Over the years, natural person and corporate credit unions have gradually evolved into quite different types of institutions. In 1977, NCUA first issued Part 704, which dealt specifically with corporate credit unions. However, it was not until 1992 that the agency broadened Part 704 to address a broad array of corporate credit union matters. See 57 FR 22626 (May 28, 1992). The regulation has been in effect for several years, during a time of great change in the credit union industry. The Agency has had an opportunity to see how the regulation has worked and to consider how it could be improved. Last year, the Board amended Section 704.12, governing representation issues. See 59 FR 59357 (Nov. 17, 1994). After consulting closely with the corporate credit union industry, credit union trade associations, and outside experts, the Board is now proposing to amend most of the remaining sections of Part 704 and to add several new sections.

Before analyzing the specific proposed changes, the Board wishes to draw the attention of interested parties to a gross inequity in the corporate credit union system. NCUA oversight and supervision of corporate credit unions has grown in complexity in the past few years, resulting in additional costs for NCUA's corporate credit union program. Although NCUA examines all of the corporate credit unions, only federally chartered corporates currently pay an operating fee to NCUA. Federally insured corporate credit unions maintain a deposit of one percent of insured shares with the NCUSIF, but corporates have minimal insured shares, and the income generated is not significant. Of course, non federally insured corporate credit unions neither pay operating fees to NCUA nor maintain deposits with the NCUSIF.

The Board is concerned that the additional monetary burden on federal credit unions puts them at a competitive disadvantage and is considering ways to level the playing field. One option is to assess all corporate credit unions an annual examination fee, to be based on the expenses associated with the NCUA corporate program. Alternatively, the Board could abolish the operating fee for federal corporate credit unions,

requiring natural person credit unions to make up the difference. Since corporate credit unions benefit natural person credit unions, it may be appropriate to ask the latter to pay for the whole system. The Board requests comment on these options.

## B. Section-by-Section Analysis

### *Section 704.1—Scope*

Part 704 applies directly to all federally insured corporate credit unions. It applies to non federally insured corporate credit unions, via Part 703 of the Rules and Regulations, if such credit unions accept shares from federally chartered credit unions. To clarify the application of Part 704, the Board is proposing to amend the Scope section so that it states both that the regulation applies to all federally insured corporate credit unions, and that non federally insured corporate credit unions must agree, by written contract, to adhere to the regulation and submit to NCUA examination as a condition of receiving funds from federally insured credit unions.

The Board considered deleting from the proposed rule Section 704.1(b), which sets forth its authority to waive a requirement of Part 704. In the few years that the provision has been in effect, NCUA has been deluged with requests for waivers. The Board is concerned that corporate credit unions may have received the impression that compliance with the rule is optional and that waivers are granted as a matter of course. The Board wishes to emphasize that corporate credit unions are expected to comply with the rule. The Board has determined to retain Section 704.1(b) in the proposed rule, however, to make clear its authority, in extraordinary circumstances, to waive provisions of the regulation.

The Board proposes to add a sentence to Section 704.1(b) regarding state-chartered credit unions. Where a state law provision is also contained in Part 704, and a state-chartered corporate wishes to request a waiver of that provision, the corporate must obtain state approval of the waiver before requesting a waiver from NCUA.

### *Section 704.2—Definitions*

#### Capital

The Board is proposing to revise the definition of capital. The revised definition encompasses primary capital and secondary capital share accounts upon which notice has not been given. These terms are defined later in this Section. The current definition includes each of the balance sheet accounts that comprise primary capital. As these

accounts are also listed in the definition of primary capital, it is not necessary to list them under capital.

#### Commitment

The Board is proposing to delete the phrase "or lease financing receivables" from the definition of "commitments," as corporate credit unions generally do not enter into lease financing arrangements.

#### Corporate Service Organization (CSO)

Currently, corporate credit unions can invest in and loan to credit union service organizations (CUSOs) as defined in Section 701.27 of the NCUA Rules and Regulations. Section 701.27 was written with natural person credit unions in mind and contains a broad list of permissible activities, many of which the Board believes are inappropriate for corporate CUSOs. Accordingly, the Board is proposing to create a new term and establish new rules for such organizations. They would be called "corporate service organizations (CSOs)" and would be limited to serving only the corporate credit unions that have invested in or loaned to the CSO and/or the members of such corporate credit unions. Thus, a CSO wholly owned by ABC Corporate Credit Union could serve only ABC and its member credit unions. If the CSO received a loan from DEF Corporate Credit Union, it could serve ABC and its member credit unions and DEF and its member credit unions. The Board believes that this restriction would preserve the integrity of field of membership requirements.

The Board is also proposing that a CSO's services be limited to data and item processing, wire transfers, record retention and storage, securities brokerage services, investment advisory services, and trust services. The Board is concerned that some corporate CUSOs currently are performing services that have nothing to do with the daily activities of corporate credit unions, such as shared branching services and home banking.

The Board is also proposing to require that a CSO be chartered as a corporation under state law.

#### Embedded Options

Embedded options are a common feature in many investment securities. Mortgage backed securities, federal agency structured notes, and many other corporate obligations have features such as maturity calls, principal prepayments, periodic and lifetime interest rate caps, and conversion factors, over which the investor has no control. The fact that these options can be exercised by the issuer (or mortgage

holder) and not the investor raises concerns for the Board.

These features entail substantial risks for investors that do not properly understand and evaluate how these options impact the performance of the investment. The function of a matched book strategy is to immunize the effects that changing interest rates will have on the economic value of assets and liabilities. If the characteristics of an asset are not replicated in the corresponding source of funds, the integrity of the match is compromised. This is especially true for assets which have conditional cash flows that are linked to the level of interest rates and other market factors.

One example of an investment with conditional cash flows is mortgage backed securities. Mortgage backed securities are impacted by the behavior of the underlying mortgage holders whose loans make up the securities. If they elect to pay off or refinance their mortgages, the securities will likewise pay down. The investor has no control over this action. Prepayment risk has a substantial impact on the market value and liquidity of an instrument and the uncertainty of the cash flow behavior makes these securities especially difficult to match.

Many investors were caught by surprise during the rate upswing in 1994 because the market values of their securities were adversely impacted far more than they had anticipated. The embedded options such as prepayment extension and caps on floating rate instruments caused a serious threat to the liquidity and solvency of many credit unions. The risk associated with such securities cannot be ignored and it must be factored into the matching strategies of corporate credit unions. This is imperative because corporate credit unions must ensure that the viability of the income, liquidity and net market value of the matched book balance sheet is not jeopardized.

#### Identically Matched

The Board recognizes that it is not possible for corporate credit unions to perfectly match all shares and certificates to identical assets because there sometimes exists an immaterial difference in dollar amount, the accrual methods, or the precise maturity date. To be substantiated as immaterial, such minute differences cannot have the effect of causing any significant exposure to changing spread performance or the net market value of the match. The integrity of the matched book depends upon how substantially close the match is with regard to such factors as the dollar amounts, rate reset

features, final maturities, and embedded options.

#### Long-Term Investment; Short-Term Investment

Section 704.6 of the current regulation frequently uses the phrases "long-term (initial maturity over 1 year) investments" and "short-term (initial maturity of 1 year or less) investments." In the interests of simplifying the regulation, the proposed rule would simply define, for the purpose of investment ratings, a "long-term investment" as one having an initial or expected maturity greater than one year and a "short-term investment" as one having an initial or expected maturity of one year or less." These definitions apply only to investment ratings in Section 704.5, which sets forth corporate credit union investment authority in the proposed rule. "Long-term" and "short-term" have different meanings in the context of asset-liability management.

#### Market Value of Portfolio Equity (MVPE)

MVPE is designed to calculate the risk that changing interest rates will have on a corporate credit union's capital. The traditional practice of measuring interest rate risk sensitivity was the static Gap model. With the introduction in recent years of more dynamic income simulation models, a more sophisticated and precise calculation of income (and capital) at risk is possible. The evolution of asset/liability management techniques has led to a greater understanding of how changing interest rates impact not only earnings but capital as well.

The Board recognizes that, like any estimation, the validity of the MVPE is dependent upon the quality of assumptions and integrity of the data going into the calculation. If the MVPE is intended to capture true mark-to-market risk of capital, the discount rates in the net present value calculations must reflect any credit, liquidity, or option premiums that are inherent in a specific asset or liability.

The development of simulation models that calculate changes in net worth for given changes in interest rates has changed the way many risk managers regard interest rate sensitivity. The MVPE calculation is significant because it is a measure that captures risk over a more long term horizon than net interest income (NII), and as such, it serves as a better early warning detection system. Where net interest income calculations typically focus on income over the next 12-24 months, MVPE captures the long-term economic

risk that is inherent in the balance sheet. It is possible for an institution's current earnings to hold steady over the near term as the mark-to-market of the balance sheet is rapidly deteriorating. If a risk manager only focuses on earnings, the risk of capital depletion may go unnoticed.

MVPE is intended to show how the economic values of both sides of the balance sheet will change in relation to one another as interest rates change. One need only look at the toll of the 1994 bear market to understand the ramifications of ignoring the risk of capital depletion. The Board is therefore compelled to ensure that all liquidity providers be cognizant of the risk exposures they take with regard to their capital and liquidity positions.

Many institutions have borrowed short-term funds to buy long-term assets. The inducement is typically a steep yield curve that provides an instant spread opportunity and quick income. The contribution of retained earnings to capital is a favorable objective but the risk of mismatched assets and liabilities can easily produce a situation where the market takes all the benefits away faster than the income was produced. The ability to withstand a liquidity crisis rests on core solvency. Maintaining core solvency, on a mark-to-market basis, in all probable interest rate environments is imperative, and MVPE is a method by which oversight authorities can police the capital at risk.

An institution that has negative capital on a mark-to-market basis cannot meet the demands or obligations of a liquidity crisis, and it is for this reason that the Board desires to expand the risk measurement techniques employed by corporate credit unions so as to detect unacceptable exposures of risk at the earliest opportunity and mandate an appropriate course of corrective action whenever necessary.

The MVPE calculation serves to inform risk takers of what the stakes are before the adverse market changes occur. By employing a "what if" scenario approach, risk managers can observe the changes in MVPE to determine the cost of entertaining certain risk exposures. It is a dynamic approach that allows the oversight authorities to know how much is at stake and to respond before problems arise.

#### Net Interest Income

The standard measure of risk in income simulation calculations is the variability of net interest income, from "most likely" expectations, for given changes in interest rates. The relationship between interest bearing

assets and liabilities is subject to adverse change when market rates rise and fall. The ability to capture the variability of returns that results from changing rates is widely regarded as a fundamental tool for managing interest rate risk.

The policy makers at corporate credit unions need to place limitations upon the amount of income that is subject to interest rate risk. Net interest income simulation is useful for understanding what variables will impact earnings and it allows the user to subject the balance sheet to severe rate stress tests and balance sheet composition changes.

"What if" analysis is essential for anticipating the damage that will result if rates move contrary to the corporate credit union's forecast. Since credit unions cannot predict interest rates, the risk of positioning the balance sheet for a specific purpose must be measured in a variety of interest rate scenarios. A net interest income simulation provides a better means for forecasting the potential risk to income posed by changing rates. Like MVPE, it helps senior management and the board of directors to determine if the levels of potential risk are acceptable.

#### Overnight

The integrity of the corporate credit union system rests on its ability to repay member funds, other than PCSAs and SCSAs, upon demand and without delay. A large portion of the funds in the system is in overnight accounts, and the bulk of those funds should remain immediately available to meet all contingent member needs. Since overnight transactions might span several days when a weekend or holiday is involved, the term "overnight" is recognized to mean from one business day to the next.

#### Penalty for Early Withdrawal

Market-based penalties on shares, deposits and liabilities are important because they protect corporate credit unions from the replacement risk that results when an early withdrawal by a member credit union can only be replaced by a higher cost alternative. This risk is tantamount to selling an investment security on the secondary market. Corporate credit unions are financial intermediaries that should not absorb the risk caused by members seeking an early redemption.

Member credit unions will have an economic incentive to request early redemption when reinvestment prospects exceed early withdrawal penalties. Unless the penalties are assessed on a contemporaneous mark-to-market basis, the corporate will have

to absorb the difference between the penalty and the replacement cost. While members may not behave in a perfect economic fashion (calculating the break-even point), the risk exposure is still significant. The incorporation of mark-to-market penalties is consistent with the principle of running a matched book.

#### Permanent Capital Share Account (PCSA)

The Board recognizes that it may be difficult for some corporate credit unions to reach the capital levels required under proposed Section 704.12 in the timeframes provided. The reports of the General Accounting Office and the Corporate Credit Union Study Committee both propose the use of a form of nonredeemable membership shares to assist, in the short-term, corporate credit unions to attain minimum capital goals. Accordingly, the Board is proposing to create a type of membership share that would be at risk, would not be redeemable without written concurrence of NCUA, and would pay non cumulative dividends. Because of these elements of permanency, up to 50 percent of primary capital could consist of PCSAs. The Board requests comment on the criteria NCUA should use to determine when PCSAs may be redeemed.

PCSAs would be limited to credit unions within the corporate credit union's field of membership, would not be subject to insurance by the NCUSIF or other deposit insurer, and could not be used to collateralize borrowings. PCSAs would be available to absorb losses in the event of a deficit in the corporate credit union's other primary capital accounts. In the event of liquidation of a corporate credit union, PCSAs would be payable only after satisfaction of all liabilities.

A corporate credit union would be required to adequately disclose the terms and conditions of PCSAs to each subscriber. A standard form for such disclosure is provided in the regulation.

#### Primary Capital

Currently, primary capital is defined as all corporate statutory and regular reserves and undivided earnings. The Board is proposing to amend the definition to have primary capital consist of statutory reserves, undivided earnings, other reserves (excluding the allowance for loan losses and

accumulated gains/losses on available-for-sale securities), net income/loss, and permanent capital share accounts (PCSAs). No more than 50 percent of primary capital would be permitted to be comprised of PCSAs. The proposed regulation would provide for several benchmarks that are tied to the level of the corporate credit union's primary capital.

#### Rated

Section 704.6 of the current regulation frequently requires that a security be rated at a certain level "by an SEC-recognized rating agency," which is defined in § 704.2. In the interests of simplifying the regulation, the proposed rule would simply define "rated" to mean "rated by an SEC-recognized rating agency," which would then be defined.

#### Secondary Capital Share Account (SCSA)

The current regulation introduced the concept of membership capital share deposits (MCSDs), which are subject to certain restrictions in order to qualify as secondary capital. The Board is proposing to retain this concept in a new form called secondary capital share accounts (SCSAs). As with PCSAs, SCSAs would be limited to credit unions within the corporate credit union's field of membership, would not be subject to insurance by the NCUSIF or other deposit insurer, could not be used to collateralize borrowings, and in the event of liquidation of a corporate credit union, would be payable only after satisfaction of all liabilities.

In order for an SCSA to count as capital, it would have to have a minimum notice of withdrawal of two years. The Board weighed several options in establishing the notice period. The Board believes that the one year notice that currently exists for MCSDs is too short. If a corporate credit union experienced problems, all of its secondary capital could be depleted in 12 months. This is often not enough time to resolve problems, and a total depletion of secondary capital could threaten a corporate credit union's continued viability. The Board believes that a two year notice period would serve to preserve capital, yet allow maneuverability on the part of member credit unions. Individual corporates would be free to set longer notice periods if they wished.

The Board also proposes that SCSAs be available to absorb losses in the event of a deficit in the corporate credit union's primary capital. SCSAs could be used not only if a corporate credit union were liquidated, but also to cover any losses in a continuing corporate credit union that has depleted its level of primary capital.

The Board is concerned that all the requirements and conditions of SCSAs are adequately disclosed to each member credit union. Therefore, specific disclosure at the time of the opening of an SCSA, and annual disclosure thereafter, is provided in the regulation, along with standard forms that may be used by the corporate credit unions.

The Board notes that SCSAs are the only permitted form of secondary capital in the proposed rule. Currently, secondary capital consists of MCSDs and term subordinated debt. A review of the corporate credit unions determined that none had in fact used term subordinated debt as a way to build secondary capital. In light of this, and the Board's belief that it is more appropriate to build capital through a corporate credit union's members, the proposed rule would not include term subordinated debt in secondary capital and would delete any reference to it in the regulation. Since SCSAs would be the only component of secondary capital, the proposed rule would simply refer to SCSAs instead of secondary capital.

#### Undivided Earnings

The Board is proposing to revise the definition of "undivided earnings" to remove the term "corporate reserves," as that term is not used in the proposed rule.

United States Government or its Agencies; United States Government-Sponsored Corporations and Enterprises

The Board is proposing to delete the reference to Appendix C from these definitions and to delete current Appendix C. Rather than having a fixed list of agencies and enterprises, which may become erroneous as entities are created, dissolved, or changed, the Board wishes to simply present the definition of government agencies and enterprises and place the responsibility of determining an entity's status on the corporate credit union.

Adjusted Trading; Bailment for Hire Contract; Cash Forward Agreement; Collateralized Mortgage Obligation; Facility; Federal Funds Transaction; Forward Rate Agreement; Futures Contract; Immediate Family Member; Market Price; Maturity Date; Official; Option Contract; Primary Dealer; Real Estate Mortgage Investment Conduit; Repurchase Transaction; Residual Interest; Reverse Repurchase Transaction; Section 107(8) Institution; Senior Management Employee; Settlement Date; Short Sale; Standby Commitment; Stripped Mortgage Backed Security; Swap Agreement; Trade Date; Zero Coupon Bond

Currently, Part 704 incorporates by reference Part 703, which governs federal credit union investments, except where inconsistent with Part 704. To eliminate the confusion that has arisen over the applicability of certain provisions of Part 703, and because Part 703 may be amended in the future, the Board is proposing to move the relevant portions of Part 703 into Part 704. Most of these definitions are from Part 703; some have been altered slightly. A few other investment-related definitions have been added.

Capital of a Broker/Dealer; Claims; Corporate Reserves; Credit Union Service Organization; Membership Capital Share Deposit; Non Credit Union Member; Original Maturity; Other Reserves; Risk-Based Capital; Secondary Capital; Speculative Activities; Term Subordinated Debt

The Board is proposing to eliminate all of these definitions, primarily because the terms are not used in the proposed regulation. The term "claims" is used in the appendices, but the definition, "loans or other debt obligations," is deemed to be self-evident.

#### *Section 704.3—Planning: Strategic and Business Plans*

The Board is proposing to revise § 704.3 to specify that the board of directors of a corporate credit union must adopt *written* strategic and business plans. The Board is concerned that the directors of corporate credit unions might develop concepts for such plans through discussion and brainstorming sessions, but not place them in formal written format. The lack of written documentation would result in the inability of the directors to monitor their success in achieving their goals. Additionally, wording was added to require that the annual review of the plans be documented and provided to

the corporate credit union's auditor and supervisory committee and to NCUA.

#### *Section 704.4—Asset/Liability Management*

*Matched book requirement.* The evolution of "managed" book strategies in the corporate credit union network has become a huge concern to the Board. The assumption of interest rate risk by some corporates has been demonstrably short-sighted as evidenced by the wide-spread exposure to rising interest rates taken by many corporates in recent years.

In some dramatic instances, portfolios were merely matched by repricing characteristics, and not always effectively at that, which subjected some corporate credit unions to potentially extreme depletions of capital. The mismatches that result when short duration liabilities are matched against longer duration investment assets cannot be managed if the ability to sell troubled assets is forfeited by a "hold-to-maturity" philosophy. Thus, the managed book approach has, in many cases, resulted in an unmanaged wager against changing interest rates.

The fact that most securities in corporate portfolios that can be adversely impacted by rising rates are classified as "hold-to-maturity" largely contradicts the notion that the risks associated with these managed portfolios can be managed when and if the wrong combination of circumstances prevails.

The Board is concerned about the potential problems that result when corporate credit unions that "manage" sources and uses of funds assume unreasonable levels of risk exposure with the overnight portion of member funds. The growth and complexity of the floating rate securities market has inspired many corporate credit unions to employ a "managed" risk approach in which maturity and average life are disregarded in favor of matching sources and uses of funds by interest rate reset characteristics.

This has led some corporate credit unions to assume substantial duration mismatches when they "match" their overnight funds against corresponding floating rate assets which have embedded options, long weighted average lives, or coupons linked to inappropriate indices. When such assets have interest rate dependent features that affect their market values, the liquidity and solvency of the credit union can be adversely affected. The Board believes that such risk exposures should be identified, measured, and limited to a reasonable level of primary capital. When such risks cannot be

immunized in the matching process, they are unacceptable.

The Board is aware that a floating rate security can have a very short duration if it is tied to a sensitive market index, reprices frequently, has little or no embedded option risk, and has a relatively short final maturity. The Board also recognizes that a portion of overnight shares at a corporate credit union represents a core amount of funds that is essentially permanent in nature. Such core funds are required to cover clearings and other daily activities. It is not inappropriate for a corporate credit union to mismatch a conservative portion of overnight funds into longer maturity assets provided that the assets are convertible to cash without suffering a material loss.

The Board is proposing that a corporate credit union be permitted to mismatch 25 percent of funds in the overnight book. The parameters set forth on the assets permitted in this 25 percent portion are established to prevent any material adverse market value effect upon the liquidation potential of these assets if and when the need arises. The ability to mismatch a conservative portion of the overnight account allows corporate credit unions to augment their earnings potential in addition to the investment of capital.

The Board does not believe that any interest rate risk should be taken with term certificates. Any source of funds, with the exception of capital, that has a maturity of greater than one business day must be identically matched to an asset that has the same maturity and repricing characteristics. The danger of entertaining duration mismatches with member certificates is regarded to be completely inconsistent with the charge of a liquidity facility. This activity is not regarded to be a legitimate means of generating retained earnings because of the risk and complexity associated with managing a mismatched portfolio.

*Portfolio pricing.* It is essential for corporate credit unions to evaluate the risk inherent in their balance sheets on a regular basis. A frequent pricing of the investment portfolio is an important component of risk assessment since it provides critical information about changes in the liquidation value of the balance sheet.

Whether assets are classified as available-for-sale or hold-to-maturity, they need to be reviewed in the context of fair market value. The management of a corporate credit union should know at all times where the relative market value of its balance sheet stands in order to ensure that the core solvency of the institution is not remotely threatened by any adverse change in market rates.

*Maximum unrealized loss on available-for-sale assets.* The Board is proposing that the aggregate loss in the accumulated unrealized gains/losses on available-for-sale assets, net of any unrealized gains or losses on the corresponding source of funds, be limited to a conservative percentage of the corporate's primary capital. Consistent with the provision that all investment securities be priced to market on a monthly basis, the need to closely monitor the impact of changing market rates on the available-for-sale portfolio is imperative.

The Board is also proposing that sufficient early withdrawal penalties be in place to guarantee protection from replacement risk. This would allow corporates to capture the economic benefit of the liabilities that are matched against available-for-sale assets; accordingly, it is appropriate to factor in the corresponding liabilities when setting a maximum limit upon the aggregate loss in the accumulated unrealized gain/loss on "available-for-sale" assets.

*Rate shock analysis.* The use of scenario analysis to measure potential risk is not a new concept to many corporate credit unions. This discipline is already resident in a number of corporates. The purpose of using a rate shock calculation is to view interest rate risk from a severe but plausible perspective. The senior management and board of directors of a corporate should always be cognizant of potential interest rate risk exposures before they arise.

It is clear that a perfectly matched book does not have the same volatility that a "managed" mismatched book has. Depending upon how the overnight and capital accounts are structured, they could potentially create some exposure to changing rates. Such exposures need to be identified, measured, related to primary capital, and reported to all oversight authorities on a regular basis.

Rate shock analysis is a standard form of risk assessment that is used in many industry applications. The FFIEC High Risk Stress Test for CMOs, total return analysis, and income simulation models all feature this approach. It is a useful and conservative practice that enhances the risk management process.

*Risk analysis, supervision and compliance.* The Board is particularly concerned that corporate credit unions have a comprehensive risk management process in place to identify all applicable risk exposures before and after an investment is made. The process should ensure that such risk exposures are measured on a regular

basis and in relation to all limitations that are in place to govern such risks.

The risk management process is a discipline that requires a large measure of vigilance on the part of management. The impact of changing market and credit conditions may be swift and severe. The risk management process must be a proactive and defensive mechanism for preserving the earnings and capital of the credit union. The more in-depth the risk analysis and the greater the frequency of review, the more accountable the board of directors can be in policing the risks that are undertaken.

The board of directors of a corporate credit union is responsible for the actions and risk exposures that the institution undertakes. In order to effectively understand and ultimately supervise risk, the board must receive a complete distillation of risk activities on a timely basis. That information must summarize the actions taken and the consequences, as stated in terms of capital at risk, that will result when applicable risk factors change.

The board of directors cannot supervise and direct the actions of the credit union at the line level. However, the board is obligated to demand that management provide all of the information necessary for board members to make fully informed decisions. Thus the reporting element of the risk management process is no less important in the scheme of managing risk. The board must have clear, concise summaries of risk activities and exposures in order to carry out its oversight responsibilities.

The Board regards risk analysis, supervision, and compliance as an essential process for all credit unions. Risk management procedures vary considerably among corporate credit unions and are a major concern. The need to standardize the discipline of the risk management process is obvious. The incorporation of a consistent framework will bolster the integrity and viability of the corporate credit union system.

*Contingency funding.* The role of all corporate credit unions as liquidity custodians has drawn attention to a major deficiency in the system. The disregard for contingent funding plans has been a particularly troublesome issue. Contingency funding plans guarantee the role of a corporate as an inviolable provider of liquidity, regardless of the circumstances. The fact that liquidity is most scarce when it is most required underscores the danger of not planning for unexpected needs.

The borrowing capacity of corporate credit unions is not an unlimited

resource. Many corporate credit unions have suggested that liquidity will be easily obtainable through repurchase agreements and lines of credit. The reality is that many factors can impinge upon the ability of a corporate to borrow the amount of funds for the amount of time that is required.

Corporate credit unions must evaluate all viable resources of liquidity on a regular basis and understand how changes in market factors will impact those resources over time. For example, it may be unreasonable to assume that borrowing capacity is not hindered by severe economic circumstances. The corporate must know that it can provide liquidity in normal or catastrophic situations. The board of directors needs to be assured that the plan to meet liquidity needs is realistic and up-to-date.

*Modeling.* The Board wishes to quantify more precisely how the proposed changes to Part 704 will affect corporate credit union earnings and capital accumulation. To this end, NCUA will conduct analytical assessments of these changes through simulation modeling techniques using a sampling of corporate credit union balance sheets. Interested parties who believe the proposed changes, if implemented, would adversely affect corporate credit unions' ability to serve their members are requested to submit the results of similar assessments to support their positions.

#### *Section 704.5—Investments*

The Board is proposing to modify and move the policies section of current § 704.6 to proposed § 704.4. The remaining sections of current § 704.6 would be revised and recodified at proposed § 704.5. The Board is also proposing to include the relevant provisions of Part 703, governing federal credit union investments, in proposed Part 704, rather than simply incorporating them by reference, as is done currently. Sections 703.4 and 703.5, with some modifications, would be included in § 704.5, and § 703.2, which provides definitions, would be included in proposed § 704.2.

Proposed § 704.5(a) would replace current § 704.6(b)(2)(i), except that the reference to investments authorized by Part 703 would be deleted. This paragraph would also explain the operation of the divestiture provisions set forth in the remainder of the section. Finally, this paragraph would address investments that must be classified as available-for-sale and the limit on investments in any one issuer. While the current rule bases all investment limitations on a percentage of assets, the

proposed rule would base those limitations on a percentage of primary capital. This would encourage the building of primary capital.

The Board has determined that a corporate credit union should not be permitted to invest in any non federally insured state banks, trust companies, and mutual savings banks, so current § 704.6(b)(2)(ii) is not included in proposed § 704.5.

Proposed § 704.5(b) would replace current § 704.6(b)(i), except that it would refer to CSOs rather than CUSOs. In addition, the limit on investments in CSOs would move to new § 704.7, which would address a number of issues relating to CSOs.

Proposed § 704.5(c) would authorize corporate credit unions to invest in U.S. Central Corporate Credit Union.

Proposed § 704.5(d) would establish limits on investments in domestic banks for the first time. Proposed § 704.5(e) would replace current § 704.6(b)(2)(iii), except that it would add an entity rating requirement for foreign banks and establish limits on investments in foreign banks in any one country and in all foreign banks.

Proposed § 704.5 (f) and (g) would replace current § 704.6(b)(2) (iv) and (v) respectively. Proposed § 704.5(h) would replace current § 704.6(b)(2)(vi), except that it would revise the stress test and would require corporate credit unions test their CMOs/REMICs on a monthly basis. Corporate credit unions would have to test floating as well as fixed rate CMOs.

Proposed § 704.5 (i)–(k) would set forth the relevant authorized activities listed in § 703.4, and proposed § 704.5(l) would set forth most of the prohibitions listed in § 703.5. The Board is proposing additionally to prohibit corporate credit unions from buying or selling swap agreements, option contracts, and forward rate agreements, and making deposits in non federally insured state banks, trust companies, and mutual savings banks. While federal natural person credit unions may purchase stripped mortgage backed securities and CMO/REMIC residuals to reduce interest rate risk, the Board is proposing to prohibit corporate credit unions from purchasing such securities for any purpose. The Board is also proposing to lower the maturity date on permissible zero coupon securities from 10 years to 5.

Finally, the Board notes that § 107(15)(B) of the Federal Credit Union Act authorizes federal credit unions to invest in mortgage related securities as defined in § 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41). Until recently, that definition

required that a security be backed by promissory notes secured by a first lien on real estate, upon which is located “a dwelling or mixed residential and commercial structure.” Because of this, a mortgage related security did not include a security backed by purely commercial mortgages. The Riegle Community Development and Regulatory Improvement Act of 1994, enacted on September 23, 1994, amended the Exchange Act to provide that the underlying notes of a mortgage related security may be directly secured by a first lien on real estate upon which is located one or more commercial structures. Thus, federal credit unions were granted the statutory authority to invest in commercial mortgage related securities.

Under § 107(15), however, this authority is “subject to such regulations as the Board may prescribe.” It is the Board’s view that federal credit unions may not purchase commercial mortgage related securities until explicitly permitted to do so by regulation. The Board has not yet issued a regulation permitting federal natural person credit unions to purchase such securities but will consider the matter in its upcoming review of Part 703. The Board will also consider at that time whether commercial mortgage related securities are appropriate for corporate credit unions. In the meantime, to eliminate potential confusion, the proposed rule explicitly prohibits corporate credit unions from purchasing such securities.

#### *Section 704.6—Capital Goals, Objectives, and Strategies*

The proposed rule would substitute “CSO” for “CUSO” and would require a cost/benefit analysis and impact study when an activity might have a material effect on a corporate credit union. When an impact study must be conducted, the proposed rule would require that it be on a corporate’s earnings, in addition to its capital position.

#### *Section 704.7—Corporate Service Organizations (CSOs)*

As noted in the definitions section, the Board is proposing to revise the CUSO concept for corporate credit unions. Currently, Part 704 incorporates much of § 701.27 by reference. Because of the proposed change in terminology, and the determination that some of the provisions of § 701.27 are not applicable to corporate credit union service organizations, proposed § 704.7 contains all of the necessary regulations governing CSOs. Therefore, the proposed rule does not reference § 701.27.

Proposed § 704.7(a) would incorporate most of the definitions in current § 701.27(c). Proposed § 704.7(b) would limit a corporate’s aggregate investments in and loans to member and non member CSOs to 15 percent of capital at the time the investment or loan is made. The current rule allows a corporate to invest 15 percent of capital in and loan 15 percent of capital to CUSOs. The Board has determined that it is inappropriate to allow corporate credit unions to risk 30 percent of capital in such organizations. The Board has added “member or non member” to the limitation to clarify that loans to and investments in all CSOs are governed by the § 704.7, regardless of whether the CSO is a member of the corporate credit union or not.

Proposed § 704.7(b) would incorporate some of the limitations of § 701.27 (b) and (d). Proposed § 704.7(c) would incorporate the conflicts provisions of § 701.27(d)(6). Proposed § 704.7(d) would replace the accounting and information access provisions of § 701.27(d)(7).

Finally, proposed § 704.7(e) would require a corporate credit union to take steps to bring its investments and loans in line with the new regulation. Under the proposed rule, corporate credit unions would not be authorized to invest in or loan to CUSOs. If a CUSO already meets the CSO requirements, an investment in or loan to the CUSO becomes an investment in or loan to a CSO, and there is no problem. If a CUSO can meet the CSO requirements with some slight adjustments, as for example, eliminating a service that a CSO may not perform, it is expected that this be accomplished by the effective date of the regulation. If there is no way that a CUSO can meet the CSO requirements, a corporate credit union must divest itself of any investments in the CUSO by the effective date of the regulation. Any loan to such a CUSO must be terminated if permitted by contract. If not permitted, a corporate credit union may retain the loan on its books but may not renew or extend it.

#### *Section 704.8—Lending*

The Board is proposing to revise § 704.7(b)(1), which would be codified at § 704.8(b)(1), to tighten the limitation on aggregate loans to one member credit union. In the existing regulation, loans to one borrower are limited to the corporate credit union’s capital or 10 percent of the corporate credit union’s shares and capital, whichever is greater. Under the proposed regulation, the aggregate of loans to one member credit union would be limited to the corporate credit union’s primary capital. The



Board believes that the existing limitation is far too permissive and poses a potential threat to the NCUSIF. In several of the larger corporate credit unions, the current limitation could allow one member to borrow in excess of \$1 billion. Limiting total loans to one borrower to the amount of a corporate credit union's primary capital would greatly reduce the exposure to the corporate credit union and the NCUSIF and, in addition, would provide an incentive to the corporate credit union to increase its level of primary capital.

The Board is proposing to eliminate § 704.7(b)(2) and (3), regarding loans to members that are not credit unions and to credit unions that are not members. Proposed § 704.8(b)(5) would explicitly prohibit a corporate from making a loan to a non member or a natural person member. Except for providing overdraft protection for a clearing account, a corporate credit union would also be prohibited from making a loan to a trade association member. Loans to CSO members would be governed by proposed § 704.7. The proposed rule would require any loan to a trade association member to be fully collateralized.

#### *Section 704.9—Borrowing*

The Board is proposing to tighten the limitations on the amount a corporate credit union may borrow. In the existing regulation, a corporate credit union is permitted to borrow up to 10 times capital or 50 percent of shares (excluding shares created by the use of member reverse repurchase agreements) and capital, whichever is greater. In the proposed regulation, the wording is changed to indicate whichever is less. The Board has determined that tying borrowing authority more closely to the level of capital would encourage capital growth. Additionally, unless extremely strong capital existed, the corporate would not be permitted to borrow up to 50 percent of shares and capital. The more well capitalized a corporate credit union, the higher borrowing capacity it would have. The Board views this as an enhancement to the safety and soundness of the corporate credit union system.

This section is also revised in the proposed regulation to restrict a corporate credit union to borrowing only to meet liquidity needs, except for issuing a minimum amount of commercial paper to maintain a market presence. As a liquidity center, a corporate credit union must have the ability to borrow funds under certain circumstances to ensure that liquidity remains available to meet member credit unions' needs. However, the Board

wishes to make it clear that corporate credit unions should not be borrowing in order to fund investment transactions to enhance net income. Therefore, the proposed regulation also requires that the need for borrowing be documented, in writing, and that the documentation be provided to the corporate credit union's auditor and supervisory committee and to NCUA.

Finally, in acknowledging that there may exist extraordinary circumstances under which a corporate credit union may need to borrow in excess of the limitation set forth in this section, the regulation allows a corporate credit union to submit a request to NCUA for additional borrowing authority.

#### *Section 704.10—Services*

The Board is proposing to revise this section to eliminate the list of services a corporate credit union may provide. Currently, corporate credit unions may provide services involving investments, liquidity management, payment systems, and correspondent services. The Board believes that this authority has, on occasion, been interpreted too broadly. Accordingly, the Board is proposing simply to say that corporate credit unions may provide services to their member credit unions, intending that to mean traditional loan, deposit and payment services. A corporate credit union wishing to provide other types of services should contact NCUA to determine whether such services are permissible.

The Board is also proposing to clarify that a corporate credit union may provide services only to its members. Historically, two corporate credit unions might informally agree between themselves for one to provide services to the members of the other. These types of correspondent arrangements are permissible for natural person credit unions, but only when the agreements are formalized in writing and certain other requirements are met. The Board has determined that such arrangements, even if formalized, are inappropriate for corporate credit unions and is proposing to state that explicitly in the regulation.

Corporate credit unions have also argued that they are authorized to provide services to non member credit unions pursuant to § 701.26 of the NCUA Rules and Regulations, which provides that a federal credit union may enter into a contract with one or more credit unions or other organizations "for the purpose of sharing, utilizing, renting, leasing, purchasing, selling, and/or joint ownership of fixed assets or engaging in activities and/or services which relate to the daily operations of credit unions." NCUA never intended

this provision to authorize corporate credit unions to provide services to non member credit unions. Such an interpretation would make field of membership limitations meaningless. The provision was intended to allow natural person credit unions to *jointly* contract to obtain services from a non credit union third party. In any event, the Board has the opportunity now to clarify that § 701.26 does not authorize corporate credit unions to provide services to non member credit unions.

Finally, corporate credit unions have argued that they can accept deposits from non member credit unions pursuant to Section 107(7)(G) of the Federal Credit Union Act, 12 USC 1757(7)(G), which authorizes federally chartered credit unions to invest in the shares or deposits of any central credit union. The Board has determined that corporate credit unions may only accept shares or deposits from members, pursuant to its authority, under Section 120(a) of the Federal Credit Union Act, 12 USC 1766(a), to issue regulations governing corporate credit unions.

#### *Section 704.11—Fixed Assets*

The Board is proposing to revise § 704.11(b)(1) to change the limitation on the amount a corporate credit union may invest in fixed assets without a waiver from NCUA. In the existing regulation, a corporate credit union may invest up to 15 percent of capital in fixed assets. In the proposed regulation, the limitation has been revised to 15 percent of primary capital. While all of the corporates are presently in compliance with the proposed limitation, some may wish to make large fixed asset investments in the future. The Board views the proposed limit as a further incentive for corporate credit unions to build stronger levels of primary capital.

Additionally, references to the Director, Office of Examination and Insurance have been changed to NCUA in the proposed rule. These references relate to the submission of waivers from the fixed asset limitation. For the time being, waivers should be submitted to the Director, Office of Corporate Credit Unions. Waivers may need to be submitted elsewhere in the future, however, if NCUA offices are restructured. Finally, the Board is proposing to eliminate the provision regarding a corporate credit union proceeding with its investment if it does not receive notification of the action taken on its request within 45 days. This will ensure that NCUA has adequate time to review any corporate credit union request to invest more than 15



percent of primary capital in fixed assets.

#### *Section 704.12—Corporate Credit Union Reserves*

A number of sources (including Congress, the General Accounting Office, and the Corporate Credit Union Study Committee) have expressed concern over the relatively low levels of capital in corporate credit unions. The proposed regulation provides for several very specific changes to the corporate credit union reserve structure. The existing regulation establishes specific levels of capital that corporate credit unions must maintain, based on risk-weighted assets. Currently, corporate credit unions must maintain a ratio of 4 percent of primary capital to risk-weighted assets and a ratio of 8 percent of total capital to risk-weighted assets.

Under proposed § 704.12(a), corporate credit unions would have to reach capital levels based on primary capital to average daily assets. The Board is proposing the changes to the reserve requirements in order to emphasize the need for stronger primary capital. The regulation provides for incremental increases in the minimum ratio of primary capital to average daily assets until the level of 4 percent is achieved by January 1, 1998. (The increments are 2.5 percent by January 1, 1996 and 3 percent by January 1, 1997.) The regulation does allow for a possible waiver from the requirements at the first two intervals. However, the Board is committed to building primary capital in corporate credit unions. Any waiver request from this requirement must include very specific time frames, with supporting documentation, for reaching the regulatory capital level.

Proposed § 704.12(b) would require that all corporate credit unions maintain a minimum of 10 percent capital to risk-weighted assets. Under the existing regulation, corporate credit unions are required to maintain a capital to risk-weighted assets ratio of 8 percent. Although the major focus will be on primary capital, the Board sees a continued need to provide a measure of capital compared to risk-weighted assets. Risk-weighting of assets does provide some delineation of the risk in a corporate credit union's balance sheet. The amount of capital available to cover the risks associated with the balance sheet is valuable information to corporate credit union officials as well as NCUA. Currently, all corporate credit unions with the exception of U.S. Central have capital to risk-weighted assets in excess of 10 percent.

Proposed § 704.12(i) would require that each corporate credit union develop

a written projection detailing its action plan to achieve the primary capital requirements established in § 704.12(a). As part of the plan, a corporate credit union will need to make reserve transfers at levels that will ensure compliance with the minimum primary capital requirements. At a minimum, corporate credit unions that have already met the minimum 4 percent primary capital requirement, must make reserve transfers as set forth in § 704.12(j).

Section 704.12(j) establishes the required reserve transfers for corporate credit unions. The proposed rule makes certain changes to conform to the proposed definitions of primary capital and capital to risk-weighted asset ratios. There are five reserve transfer categories. All corporate credit unions would be required to maintain minimum primary capital to average daily assets of 4 percent and capital to risk-weighted assets of 10 percent. Therefore, Category 1 begins when these ratios are at 4 percent and 10 percent respectively. Once the primary capital ratio is greater than 6 percent, and the capital to risk-weighted assets ratios is greater than 20 percent, reserve transfers are no longer required. For the purposes of reserve transfers, it is proposed that PCSAs be excluded from primary capital.

The Board is proposing to eliminate the term "risk-based capital." In the current regulation, risk-based capital includes primary capital and secondary capital up to 100 percent of primary capital. Risk-based capital is used in comparison to risk-weighted assets to establish minimum risk-based capital ratios for reserving purposes. In the proposed regulation, reserve transfers are based on primary capital to average daily assets and capital to risk-weighted assets. There would no longer be any specific category of risk-based capital.

#### *Section 704.13—Representation*

As noted earlier, the Board amended the representation section of Part 704 last year. In light of the proposed changes to the definition of "member," the Board is proposing to delete certain provisions that were designed to ensure that corporate credit unions were controlled by their member credit unions. These provisions would no longer be necessary if only representatives of member credit unions are permitted to vote and stand for election. The Board is also proposing to specifically state that the provisions of § 701.14 of the Rules and Regulations, governing changes in officials and senior executive officers in credit unions that are newly chartered or in

troubled condition. This provision always was intended to apply to corporate credit unions, as it is not inconsistent with any provision in Part 704. However, the provision refers to NCUA Regional Directors, and in light of the centralization of the corporate credit union program, its application to corporate credit unions may have been unclear. Accordingly, the Board is proposing to specifically include § 701.14 in Part 704, changing the reference from "Regional Director" to "NCUA." As with requests for waivers to the fixed asset limitation, notices required under § 701.14 should be filed, for the time being, with the Director, Office of Corporate Credit Unions.

#### *Section 704.14—Audit Requirements*

In the existing regulation, this section deals only with the need for an annual audit. The only change relating to the annual audit in the proposed regulation is the addition of wording to clearly specify that the annual opinion audit will include a letter of reportable conditions.

The Board is proposing to add a new § 704.14(b) to include a requirement for an internal auditor function in corporate credit unions with assets in excess of \$100 million. The requirement would also apply to corporates with assets under \$100 million, if so ordered by NCUA. The Board realizes that not all corporate credit unions can readily afford to hire a full-time internal auditor. Based on the asset size and complexity of the institution, the corporate could hire a part-time internal auditor or contract with an outside firm to perform the internal auditor function. The proposed regulation requires that the internal auditor report directly to the chair of the corporate credit union's supervisory committee. The regulation provides specific minimum responsibilities that the internal auditor must perform. Finally, the internal auditor's findings and reports must be documented and made available for review to the outside auditor and NCUA.

#### *Section 704.15—Contracts/Written Agreements*

The Board is not proposing any changes to this provision.

#### *Section 704.16—State-Chartered Corporate Credit Unions*

The Board is proposing to add new § 704.16(b) to put non federally insured state-chartered corporate credit unions that receive funds from federally insured credit unions on notice that they are considered "institution-affiliated parties" within Section 206(r)

of the Federal Credit Union Act and subject to all of the enforcement provisions of the Act.

#### *Section 704.17—Fidelity Bond Coverage*

The Board is proposing only minor changes to this Section. Section 704.17(d) would be amended to clarify that the minimum bond coverage is based on a corporate credit union's average daily assets as of the preceding December 31. The Board notes that in current § 704.17(f), the deductibles are based on a corporate credit union's primary capital to risk asset ratio. Since the proposed regulation eliminates this ratio, another one must be used. The Board is proposing that it be the primary capital ratio and specifically requests comments on this issue.

#### *Section 704.18—Effective Date*

The Board is proposing to make any final regulation on these matters effective January 1, 1996. However, although not stated in the proposed regulation itself, the Board is also considering requiring compliance with § 704.5, governing investments, 30 days after the final rule is published in the **Federal Register**. Investments purchased before that date would be governed by the regulation in effect at the time of purchase. The Board is proposing to make the investment provisions applicable before the remainder of the regulation to deter corporate credit unions from "loading up" on investments that would no longer be permissible after January 1, 1996. All investments, regardless of when acquired, would be subject to the asset-liability provisions of proposed Section 704.4. In order to accomplish this objective, it may be necessary for the Board to issue a final rule in two separate stages with different effective dates, or to issue one rule with a 30 day effective date, but with a delayed compliance date for all sections other than §§ 704.2, Definitions, and 704.5, Investments.

#### **Appendix A—Summary of Risk Weights and Risk Categories for Corporate Credit Unions**

The major focus of the Board's proposed amendments to the risk weight schedule is the risk weighting of certain mortgage-backed securities. The current regulation weights CMOs based on their response to the interest-rate sensitivity test, and the Board has determined that this is inappropriate in a scheme designed to address credit risk. In the proposed rule, mortgage-backed securities, including pass throughs and certain CMOs (but not stripped mortgage backed securities), that are issued or guaranteed by a U.S. Government agency or U.S. Government-sponsored enterprise are assigned to the risk

weight category appropriate to the issuer or guarantor. Generally, a privately-issued mortgage backed security meeting certain criteria, as set forth in the proposed regulation, is treated as essentially an indirect holding of the underlying assets, and assigned to the same risk category as the underlying assets. Privately-issued mortgage backed securities whose structures do not qualify them to be regarded as indirect holdings of the underlying assets are assigned to the 100 percent risk category.

While the risk category to which mortgage backed securities is assigned will generally be based upon the issuer or guarantor or, in the case of privately-issued mortgage backed securities, the assets underlying the security, any class of a mortgage backed security that can absorb more than its pro rata share of loss without the whole issue being in default, is assigned to the 100 percent risk category.

The specific changes being proposed are as follows. In Category 1, the Board is proposing to delete item (g), claims on or unconditionally guaranteed by sovereign central governments of "AAA" rated countries. Its inclusion in the current rule was inadvertent, as such investments are not permissible for corporate credit unions.

In Category 2, 20 percent risk weight, the Board is proposing to delete the material at the end of Category 2, addressing bank ratings. Proposed Section 704.5 sets forth the minimum ratings for deposits in banks. The Board is also proposing to delete items (j) and (k), which are certain types of repurchase transactions. Such transactions should be risk weighted according to the type of collateral involved. Item (m), CMOs/REMICs that pass the interest rate sensitivity test, would also be deleted from the regulation. As noted above, the proposed rule risk weights CMOs based on the issuer, guarantor, or assets underlying the security. Finally, the Board is proposing to change the risk weighting of claims on foreign banks from 20 percent to 50 percent.

In Category 3, 50 percent risk weight, the Board is proposing to delete item (b), CMOs that pass the interest rate sensitivity test, and replace it with privately-issued mortgage backed securities that meet certain criteria relating to credit risk. Claims on foreign banks would be added to this category.

In Category 4, 100 percent risk weight, the Board is proposing to delete investments in CUSOs from item (a), as corporate credit unions would not be permitted to hold such investments from the effective date of this regulation. The proposed rule would add item (b), loans to and investments in CSOs, and replace item (e), membership capital share deposits, with permanent and secondary capital share accounts. The Board is also proposing to delete item (d), hold-in-custody repurchase agreements, as the risk weighting of such agreements should be based on the underlying collateral. The Board is proposing to delete item (f), stripped mortgage backed securities and item (g), residual interests of CMOs/REMICs. Under the proposed rule, these investments would not be permissible for corporate credit unions. In this category, the Board is also proposing to add an item for other claims on private obligors, to make it clear that unless

a claim on a private obligor is guaranteed or insured by a U.S. Government agency or enterprise, is collateralized by such a claim, or is secured or collateralized by highly liquid and reliable collateral, it is risk-weighted at 100 percent.

#### **Appendix C—Model Forms**

As noted earlier, the Board is proposing to delete the current Appendix C as unnecessary and potentially confusing. The proposed rule contains a new Appendix C, which features model disclosure forms for permanent and secondary capital share accounts. Corporate credit unions that use these forms will be deemed to be in compliance with the proposed disclosure requirements of § 704.2.

#### *Section 741.3—Other Requirements*

The Board is proposing to amend § 741.3 of the NCUA Rules and Regulations, governing requirements for insured credit unions, to prohibit federally insured credit unions from transacting business with corporate credit unions that do not comply with Part 704 and are not examined by NCUA.

#### **Regulatory Procedures**

##### *Regulatory Flexibility Act*

The NCUA Board certifies that the proposed rule, if made final, will not have a significant economic impact on small credit unions (those under \$1 million in assets). The rule applies only to corporate credit unions, all of which have assets well in excess of \$1 million. Accordingly, a Regulatory Flexibility Analysis is not required.

##### *Paperwork Reduction Act*

The proposed rule contains a requirement for the collection of additional information and a maintenance of documentation by a corporate credit union. The proposed rule requires that each corporate credit union develop and implement certain policies and plans and document compliance with such policies and plans. The proposed rule also requires that certain information regarding asset-liability management and investments be sent to NCUA or maintained in the records of the corporate credit union.

The paperwork requirements will be submitted to the Office of Management and Budget (OMB) for review under the Paperwork Reduction Act. Written comments on the paperwork requirements should be forwarded directly to the OMB Desk Officer indicated below at the following address: OMB Reports Management Branch, New Executive Office Building, Room 10202, Washington, DC 20530. Attn: Milo Sunderhauf. NCUA will publish a notice in the **Federal Register**

once OMB action is taken on the submitted request.

#### *Executive Order 12612*

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. It states that: "Federal action limiting the policy-making discretion of the states should be taken only where constitutional authority for the action is clear and certain, and the national activity is necessitated by the presence of a problem of national scope." The risk of loss to federally insured credit unions and the NCUSIF caused by actions of corporate credit unions are concerns of national scope. The proposed rule would help assure that proper safeguards are in place to ensure the safety and soundness of corporate credit unions.

The rule applies to all corporate credit unions that accept funds from federally insured credit unions. The NCUA Board believes that the protection of such credit unions, and ultimately the NCUSIF, warrants application of the proposed rule to non federally insured corporate credit unions. The NCUA Board, pursuant to Executive Order 12612, has determined that this rule may have an occasional direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. However, the potential risk to the NCUSIF without these changes justifies them.

#### **List of Subjects**

##### *12 CFR Part 704*

Credit unions, Reporting and recordkeeping requirements.

##### *12 CFR Part 741*

Bank deposit insurance, Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on April 13, 1995.

**Becky Baker,**

*Secretary of the Board.*

For the reasons set forth in the preamble, NCUA proposes to amend 12 CFR chapter VII as follows:

1. Part 704 is revised to read as follows:

#### **PART 704—CORPORATE CREDIT UNIONS**

Sec.

704.1 Scope.

704.2 Definitions.

704.3 Planning; strategic and business plans.

704.4 Asset/liability management.

704.5 Investments.

704.6 Capital goals, objectives, and strategies.

704.7 Corporate Service Organizations (CSOs).

704.8 Lending.

704.9 Borrowing.

704.10 Services.

704.11 Fixed assets.

704.12 Corporate credit union reserves.

704.13 Representation.

704.14 Audit requirements.

704.15 Contracts/written agreements.

704.16 State-chartered corporate credit unions.

704.17 Fidelity bond coverage.

704.18 Effective date.

#### **Appendix A to Part 704—Summary of Risk Weights and Risk Categories for Corporate Credit Unions**

#### **Appendix B to Part 704—Off-Balance Sheet Credit Conversion Factors**

#### **Appendix C to Part 704—Model Forms**

**Authority:** 12 U.S.C. 1762, 1766(a), 1781, and 1789.

##### **§ 704.1 Scope.**

(a) This part establishes special rules for all federally insured corporate credit unions. Non-federally insured corporate credit unions must agree, by written contract, to both adhere to the requirements of this part and submit to examinations, as determined by NCUA, as a condition of receiving shares or deposits from federally insured credit unions. This part grants certain additional authorities to federal corporate credit unions. Except to the extent that they are inconsistent with this part, other provisions of NCUA's Rules and Regulations (12 CFR Parts 700–795) and the Federal Credit Union Act apply to federally chartered corporate credit unions and federally insured state-chartered corporate credit unions to the same extent that they apply to other federally chartered and federally insured state-chartered credit unions, respectively.

(b) The NCUA Board has the authority to issue orders which vary from this Part. This authority is provided under Section 120(a) of the Federal Credit Union Act, 12 U.S.C. 1766(a). Requests by state-chartered corporate credit unions for waivers to this part must be approved by the state regulator before being submitted to NCUA.

##### **§ 704.2 Definitions.**

*Adjusted trading* means any method or transaction used to defer a loss whereby a corporate credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another security at a price above its current market price.

*Asset-backed securities (ABS)* means all securities supported by installment loans or leases or by revolving lines of credit. This definition excludes those securities referred to in the financial markets as mortgage-backed securities (MBS) which includes collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs).

*Average daily assets* means the daily average of net assets calculated on the basis of assets at the close of each day in the period.

*Average life* means the weighted average time to principal repayment with the amount of the principal paydowns (both scheduled and unscheduled) as the weights.

*Bailment for hire contract* means a contract whereby a third party, bank, or other financial institution, for a fee, agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

*Capital* means the total of all primary capital and secondary capital share accounts upon which notice of withdrawal has not been given.

*Cash forward agreement* means an agreement to purchase or sell a security with delivery and acceptance being mandatory and at a future date in excess of thirty (30) days from the trade date.

*Collateralized mortgage obligation (CMO)* means a multi-class bond issue collateralized by whole loan mortgages or mortgage-backed securities (MBS).

*Commitment* means any unconditional arrangement that obligates a corporate credit union to extend credit in the form of loans; to purchase loans, securities or other assets; or to participate in loans and leases. Commitments also include overdraft facilities, revolving credit, home equity, and mortgage lines of credit, and similar transactions. An obligation is conditional if the corporate credit union is not automatically obligated to extend funds.

*Corporate credit union* means an organization that:

- (1) Is chartered under Federal or state law as a credit union;
- (2) Receives shares from and provides loan services to credit unions;
- (3) Is operated primarily for the purpose of serving other credit unions;
- (4) Is designated by NCUA as a corporate credit union;
- (5) Limits natural person members to the minimum required by state or federal law to charter and operate the credit union; and
- (6) Does not condition the eligibility of any credit union to become a member on that credit union's membership in any other organization.

*Corporate service organization (CSO)* means an entity that:

(1) Serves only corporate credit unions that have made investments in or loans to the entity and/or the member credit unions of such corporate credit unions;

(2) Limits the services it provides to data and item processing, wire transfers, record retention and storage, securities brokerage services, investment advisory services, and trust services; and

(3) Is chartered as a corporation under state law.

*Credit equivalent amount* means the face amount of each off-balance sheet item multiplied by a credit conversion factor outlined in Appendix B of this part.

*Embedded options* mean characteristics of certain assets and liabilities which give the issuer of the instrument the ability to change the features such as final maturity, rate, principal amount and average life. These options include, but are not limited to, caps, floors, and prepayment options. These options are found in most mortgage-backed securities, structured notes, and some Network instruments.

*Expected maturity* means the date on which all remaining principal amounts of an instrument or bond are anticipated to be paid off on the basis of projected payment assumptions.

*Facility* means the home office of a corporate credit union or any suboffice thereof including, but not necessarily limited to, wire service, telephonic station, or mechanical teller station.

*Federal funds transaction* means a short-term or open-ended transfer of funds between U.S. depository institutions.

*Federally issued CMO/REMIC* means a CMO or REMIC which is issued by a U.S. Government agency or a U.S. Government-sponsored corporation or enterprise.

*Foreign bank* means an institution which is organized under the laws of a country other than the United States, which is engaged in the business of banking, and which is recognized as a bank by the banking supervisory authority of the country in which it is organized.

*Forward rate agreement* means an over-the-counter market instrument that allows two parties to trade interest rates on a notional principal amount for a specified time period in the future.

*Futures contract* means a contract for the future delivery of commodities, including certain government securities, sold on commodities exchanges.

*Identically matched* means matched, to the extent possible, by amount,

repricing, behavior, and final maturity. Any embedded options, such as calls, caps, and prepayments, must be replicated in the corresponding source or use of funds.

*Immediate family member* means a person related by blood, marriage, or adoption.

*Long-term investment* means, for the purpose of issue ratings, an investment that has an initial maturity, or expected maturity, greater than one year.

*Market price* means the price at which a security can be bought or sold.

*Market value of portfolio equity (MVPE)* means the net market value of all assets and liabilities, including their embedded options. This reflects the liquidation value of the balance sheet.

*Material* means an amount that exceeds 5 percent of the corporate credit union's capital.

*Maturity date* means the date on which a security matures, and shall not mean the call date or the average life of the security.

*Member reverse repurchase transaction* means an integrated transaction in which a corporate credit union purchases a security from one of its member credit unions under agreement by that member credit union to repurchase the same security at a specified time in the future. The corporate credit union then sells that same security, on the same day, to a third party, under agreement to repurchase it on the same date on which the corporate credit union is obligated to return the security to its member credit union.

*Net assets* means total assets less Central Liquidity Facility (CLF) stock subscriptions, CLF loans guaranteed by the NCUSIF, U.S. Central CLF certificates, and member reverse repurchase transactions.

*Net interest income* means the difference between income earned on interest bearing assets and interest paid on interest bearing liabilities.

*Official* means any director or committee member.

*Option contract* means a right, but not an obligation, to buy or sell a security at a specified price and settlement date in the future.

*Overnight* means having a maturity or call date of one business day.

*Penalty for early withdrawal* of a share, deposit, or liability means a fee which will, at a minimum, fully compensate a corporate credit union for the difference between fair value and book value of the asset that is divested (including any accumulated unrealized losses since the asset was purchased), or the replacement cost of funds, to meet the demand for early withdrawal.

*Permanent capital share account (PCSA)*. (1) PCSA means a share account that:

(i) Is restricted to credit unions within a corporate credit union's field of membership;

(ii) Is not subject to share insurance coverage by the NCUSIF or other deposit insurer;

(iii) Cannot be used by member credit unions to collateralize borrowings;

(iv) Is available to absorb losses in the event of a deficit in other primary capital accounts in the corporate credit union;

(v) In the event of liquidation of the corporate credit union, is payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF;

(vi) Is redeemable only with the written concurrence of NCUA; and

(vii) Pays noncumulative dividends.  
(2) The terms and conditions of permanent capital share accounts must be disclosed at the time an account is opened. The board of directors of the member credit union must acknowledge those terms and conditions by signing a disclosure form. A copy of the disclosure form must be given to the member credit union, with the original retained by the corporate credit union.

*Primary capital* means statutory reserves, undivided earnings, other reserves (excluding the allowance for loan losses and accumulated unrealized gains/losses on available-for-sale securities), net income (loss), and permanent capital share accounts (PCSAs). No more than 50 percent of primary capital may be comprised of PCSAs.

*Primary dealer* means a bank or investment dealer authorized to buy and sell government securities in direct dealings with the Federal Reserve Bank of New York in its execution of Fed open market operations.

*Privately issued CMO/REMIC* means a CMO or REMIC that qualifies as a permissible investment for a federal credit union pursuant to the provisions of Section 107(15)(B) of the Federal Credit Union Act.

*Rated*, in the context of investments under § 704.5, means rated by an SEC-recognized rating agency. An SEC-recognized rating agency is any firm recognized by the Securities and Exchange Commission (SEC) as qualified to assign risk ratings to various investment instruments required to be registered with the SEC.

*Real Estate Mortgage Investment Conduit (REMIC)* means a nontaxable entity formed for the sole purpose of holding a fixed pool of mortgages

secured by an interest in real property and issuing multiple classes of interests in the underlying mortgages.

*Repurchase transaction* means a transaction in which a corporate credit union agrees to purchase a security from a counterpart and to resell the same or any identical security to that counterpart at a later date.

*Residual interest* means the remainder cash flows from a CMO or REMIC transaction after payments due bondholders and trust administrative expenses have been satisfied.

*Reverse repurchase transaction* means a transaction whereby a corporate credit union agrees to sell a security to a purchaser and to repurchase the same or any identical security from that purchaser at a future date and at a specified price.

*Risk-weighted assets* means the sum of total balance sheet assets and off-balance sheet credit equivalent amounts multiplied by their appropriate risk weights.

*Secondary capital share account.* (1) Secondary capital share account means a share account that:

(i) Is restricted to credit unions within a corporate credit union's field of membership;

(ii) Is not subject to share insurance coverage by the NCUSIF or other deposit insurer;

(iii) Is established, at a minimum, as a two year notice account;

(iv) Cannot be used by member credit unions to collateralize borrowings;

(v) Is available to absorb losses in the event of a deficit in primary capital in the corporate credit union; and

(vi) In the event of liquidation of the corporate credit union, is payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

(2) Notwithstanding the notice requirement, in the case of a member credit union's merger or liquidation, a corporate credit union shall return the member's secondary capital shares, less any penalty for early withdrawal, within 30 days of written notification from NCUA.

(3) The terms and conditions of secondary capital share accounts must be disclosed at the time an account is opened. The board of directors of the member credit union must acknowledge those terms and conditions by signing a disclosure form. A copy of the disclosure form must be given to the member credit union, with the original retained by the corporate credit union. A statement of the terms and conditions of a secondary capital share account must be provided to member credit

unions annually. The annual disclosure statement must be signed by the chairman of the board of the corporate credit union.

*Section 107(8) institution* means an institution described in Section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)).

*Senior management employee* means the corporate credit union's chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager) and the chief financial officer (controller).

*Settlement date* means the date originally agreed to by a corporate credit union and a counterpart for settlement of the purchase or sale of a security.

*Short sale* means the sale of a security not owned by the seller.

*Short-term investment* means, for the purpose of issue ratings, an investment that has an initial maturity, or expected maturity, of one year or less.

*Standby commitment* means a commitment to either buy or sell a security, on or before a future date, at a predetermined price. The seller of the commitment is the party receiving payment for assuming the risk associated with committing either to purchase a security in the future at a predetermined price, or to sell a security in the future at a predetermined price. The seller of the commitment is required to either accept delivery of a security (in the case of a commitment to buy) or make delivery of a security (in the case of a commitment to sell), in either case at the option of the buyer of the commitment.

*Stripped mortgage-backed security (SMBS)* means a security that represents either the principal or interest only portion of the cash flows of an underlying pool of mortgages.

*Swap agreement* means a contract to exchange interest payments that are based upon a specified dollar amount (the "notional") at specified dates in the future.

*Trade association* means an association of organizations or persons formed to promote their common interests. The term includes entities owned or controlled directly or indirectly by such an association but does not include credit unions.

*Trade date* means the date a corporate credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

*Undivided earnings* means all forms of retained earnings, except:

(1) Regular or statutory reserves; and  
(2) Valuation allowances established to meet the full and fair disclosure requirements of § 702.3 of this chapter.

*United States depository institutions* means offices or branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the United States, Puerto Rico, and U.S. territories and possessions. This includes banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, international banking facilities of domestic depository institutions, and U.S. chartered depository institutions owned by entities outside of the United States.

*United States Government or its agencies* means the United States Government or instrumentalities of the United States whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States Government.

*United States Government-sponsored corporations and enterprises* means agencies originally established or chartered to serve public purposes specified by Congress, but whose obligations are not explicitly guaranteed by the full faith and credit of the United States Government.

*Wholesale corporate credit union* means a corporate credit union that serves other corporate credit unions.

*Zero coupon bond* means a debt obligation that makes no periodic interest payments but instead is sold at a discount from its face value. The holder of a zero coupon bond realizes the rate of return through the gradual appreciation of the security, which is redeemed at face value on a specified maturity date.

#### § 704.3 Planning; strategic and business plans.

(a) The board of directors of a corporate credit union shall adopt a written strategic plan with appropriate objectives and goals. This plan will be reviewed periodically during the year to determine that the goals are being accomplished. At least annually, the strategic plan will be reviewed and updated. These reviews will be documented in writing and provided upon request to the auditor, supervisory committee, and NCUA.

(b) A written business plan will be prepared for any material expenditure in fixed assets, new products and services, or investments in a CSO and/or for any planned field of membership expansion. Such plans shall be provided upon request to the auditor, supervisory committee, and NCUA.

**§ 704.4 Asset/liability management.**

(a) *Matching.* All shares and deposits, exclusive of permanent capital share accounts and secondary capital share accounts, whether fixed or variable rate, must be identically matched to a corresponding asset. An identical match means that any factor which impacts the cash flows of an asset must be identically replicated in the corresponding liability. The corporate's capital is exempt from the matching requirement. The overnight shares of a corporate credit union are subject to the matching requirement with the following exception: Up to, but no more than, 25 percent of a corporate credit union's overnight shares and deposits (based on the average daily overnight balance for the preceding calendar year) can be matched against variable rate securities with a final maturity of three years or less provided that the following provisions are met: the security coupon reprices at least monthly, the coupon formula is tied to an appropriate market index (such as LIBOR, PRIME, Fed funds and Treasury Bills) not a lagging indicator (such as COFI); the change in coupon formula is not inverse to or a multiple of the change in the market index, and, if the asset is a marketable security, is classified as "available for sale".

(b) *Unmatched embedded option limitation.* A corporate credit union is limited to an aggregate amount of instruments that possess unmatched embedded options of no more than capital.

(c) *Penalty for early withdrawal.* All shares and deposits must either be non redeemable or include a fair value penalty for early withdrawal as defined in § 704.2.

(d) *Portfolio pricing.* The fair value of all investment securities, regardless of classification, must be calculated and documented on a monthly basis using reliable market price indicators. Such documentation shall be provided upon request to the auditor, supervisory committee, and NCUA.

(e) *Maximum unrealized loss on "available-for-sale" assets.* The aggregate loss in the accumulated unrealized gains/losses on "available-for-sale" assets, net of any unrealized gains/losses on the corresponding source of funds, may not exceed 15 percent of primary capital excluding accumulated unrealized gains/losses on available for sale securities. Any violation of this limit must be addressed with a corrective action that reduces the loss below the maximum allowed within 10 days.

(f) *Rate shock analysis.* A corporate credit union must perform a monthly

"shock test" calculation to show the impact upon its net interest income and market value of portfolio equity (MVPE) for an immediate and sustained tandem shift in interest rates of plus and minus 300 basis points. The MVPE cannot change by more than plus or minus 25 percent for a plus or minus 300 basis point rate shock. The documentation for these calculations must include the balance sheet categories, interest rates, and other assumptions used. This information must be presented to a senior committee that includes board membership and provided upon request to the auditor, supervisory committee and NCUA.

(g) *Risk analysis.* A corporate credit union must identify and list all risks associated with an asset or source of funds prior to purchase or issuance. Where applicable, the risk analysis must include, at a minimum, liquidity, market, credit, legal, systems/operations, sovereign, exchange, and management risks. The risk analysis shall be maintained with other supporting documentation in a permanent record, which shall be provided upon request to the auditor, supervisory committee, and NCUA.

(h) *Risk supervision.* A corporate credit union must identify, measure, and document the risks associated with all assets. The measure of risk exposure and a comparison of such exposure to board policy limits must be reported in writing on a quarterly basis. Such reports shall be provided upon request to the auditor, supervisory committee, and NCUA.

(i) *Risk compliance.* A corporate credit union must review all investment assets on a monthly basis for compliance with NCUA Rules and Regulations and board of director policies to determine whether any such assets require divestiture. The results and analysis shall be provided upon request to the auditor, supervisory committee, and NCUA.

(j) *Contingency funding.* A corporate credit union must develop a contingency funding plan that ranks, in order of priority, all sources of liquidity, by category and amount, that are available to service an immediate outflow of member funds. The plan must analyze the impact that potential changes in fair value will have on the disposition of assets in a variety of interest rate scenarios and be reviewed by a committee of the board no less frequently than annually or as market and business conditions dictate. The plan and annual review shall be provided upon request to the auditor, supervisory committee, and NCUA.

(k) *Policies.* Corporate credit unions must develop and implement comprehensive written policies, which shall be reviewed annually and provided upon request to the auditor, supervisory committee, and NCUA. The policies must address, at a minimum, the following:

- (1) Diversification of assets by issuer, type and risk;
- (2) Approved issuers, instruments, and broker-dealers;
- (3) Liabilities, including pricing strategies, diversification and penalties for early withdrawal;
- (4) Limits on the maximum permitted change in net interest income as calculated for a plus and minus 300 basis point rate shock;
- (5) Acceptable credit risk;
- (6) Authorization of and limitations on persons/committees involved with asset/liability management.

**§ 704.5 Investments.**

(a) A corporate credit union may invest in those securities, deposits, and obligations set forth in Sections 107(7), 107(8), and 107(15)(B) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8), and 1757(15)(B)), except as provided in this section. Any asset that has the potential to be divested must be classified as available-for-sale. An asset downgraded by the same rating agency used when the investment was purchased must be divested within 10 business days of the downgrade. Other than investments in wholesale corporate credit unions, CSOs, and repurchase transactions, the aggregate of a corporate credit union's investments in any one institution, issuer, or trust is limited to 25 percent of the corporate credit union's primary capital at the time of purchase.

(b) A corporate credit union may invest in CSOs, as defined in § 704.2 and subject to the limitations of § 704.7.

(c) A corporate credit union may invest in deposits in, the sale of Federal Funds to, and debt obligations of wholesale corporate credit unions.

(d)(1) A corporate credit union may invest in deposits in, the sale of Federal Funds to, and debt obligations of Section 107(8) institutions subject to the following requirements:

- (i) The institution must have assets of at least US \$5 billion and an entity rating no lower than B (or equivalent);
  - (ii) The investment must be rated no lower than A-1 (or equivalent) for short-term investments and no lower than AA (or equivalent) for long-term investments; and
  - (iii) The investment must be denominated in United States dollars.
- (2) A written evaluation of lines of exposure to all Section 107(8)

institutions must be prepared quarterly by qualified staff and approved by an appropriate committee of the board so that changes in credit quality can be detected at the earliest opportunity. This approval must be documented in the minutes of the committee and be provided upon request to the auditor, supervisory committee, and NCUA.

(e)(1) A corporate credit union may invest in deposits in, the sale of Federal Funds to, and debt obligations of foreign banks, subject to the following requirements:

(i) The bank must have assets of at least US \$20 billion and an entity rating no lower than A/B (or equivalent);

(ii) The investment must be rated no lower than A-1 (or equivalent) for short-term investments and no lower than AA (or equivalent) for long-term investments;

(iii) The investment must be denominated in United States dollars;

(iv) The country in which the issuing bank is organized must be rated AAA (or equivalent) for political and economic stability;

(v) Aggregate investments in banks in any single foreign country are limited to 50 percent of the corporate credit union's primary capital at the time of purchase; and

(vi) Aggregate investments in all foreign banks are limited to 300 percent of the corporate credit union's primary capital at the time of purchase.

(2) A written evaluation of lines of exposure to all foreign banks must be prepared quarterly by qualified staff and approved by an appropriate committee of the board so that changes in credit quality can be detected at the earliest opportunity. This approval must be documented in the minutes of the committee and be provided upon request to the auditor, supervisory committee, and NCUA.

(f) A corporate credit union may invest in marketable debt obligations of corporations chartered in the United States, provided that the obligations are rated not lower than A-1 (or equivalent) for short-term investments and not lower than AA- (or equivalent) for long-term investments. A marketable obligation is one that may be sold with reasonable promptness at a price which corresponds reasonably to its fair value. This authority does not apply to debt obligations that are convertible into the stock of the corporation.

(g) A corporate credit union may invest in asset-backed securities subject to the following requirements:

(1) Rated not lower than AAA (or equivalent); and

(2) Having an average life at the time of purchase not to exceed 5 years.

(h) A corporate credit union may invest in federally and privately issued CMOs/REMICs, subject to the following limitations:

(1) All investments in fixed rate CMOs/REMICs must meet the following NCUA-modified FFIEC High Risk Security Test requirements:

(i) The weighted average life of the security may not exceed 5 years at the time of purchase;

(ii) The weighted average life may not extend by more than 2 years nor contract by more than 3 years for an instantaneous shift in market rates of plus or minus 300 basis points;

(iii) The investment's price may not decline by more than 10 percent for an instantaneous shift in market rates of plus or minus 300 basis points.

(2) All investments in floating rate CMOs/REMICs must meet the following NCUA-modified FFIEC High Risk Security Test requirements:

(i) The weighted average life of the security may not exceed 5 years at the time of purchase;

(ii) The weighted average life may not extend by more than 2 years nor contract by more than 3 years for an instantaneous shift in market rates of plus or minus 300 basis points;

(iii) The investment's price may not decline by more than 5 percent for an instantaneous shift in market rates of plus or minus 300 basis points.

(3) The prepayment assumption for the underlying mortgages shall be based on an industry standard median prepayment estimate or the median estimate of no fewer than five independent brokerage firms, at least one of which must be a primary dealer. When estimates from specific dealers are used, those dealers must be approved by an appropriate committee and listed along with monthly test results. The same industry standard or selection of dealers must be used for all CMO/REMIC securities each time the tests are performed. In computing the average life of a CMO/REMIC investment, it must be assumed that the anticipated rate of prepayment remains constant over the remaining life of the mortgage collateral.

(4) Any CMO/REMIC security that fails the average life standard or the price sensitivity test shall be divested within 10 business days.

(5) Results of monthly CMO/REMIC tests must be documented and reviewed by an appropriate committee and maintained in a permanent record. Such results shall be provided upon request to the auditor, supervisory committee, and NCUA.

(i) A corporate credit union may enter into a cash forward agreement to

purchase or sell a security, provided that:

(1) The period from the trade date to the settlement date does not exceed one hundred and twenty (120) days;

(2) If the credit union is the purchaser, it has written cash flow projections evidencing its ability to purchase the security;

(3) If the credit union is the seller, it owns the security on the trade date; and

(4) The cash forward agreement is settled on a cash basis at the settlement date.

(j) A corporate credit union may enter into a repurchase or reverse repurchase transaction provided that the collateral securities are permissible investments for corporate credit unions and the transaction is priced to reflect accrued interest, the risk of the securities, and the term of the trade. A corporate credit union purchasing a security in a repurchase transaction must take physical possession of the security, receive written confirmation of the purchase and a safekeeping receipt from a third party under a written bailment for hire contract, or be recorded as the owner of the security through the Federal Reserve Book-Entry System. A corporate credit union obtaining funds from a reverse repurchase transaction may not invest those funds for a term greater than the maturity date of the reverse repurchase transaction. A repurchase transaction shall be considered to have a credit exposure of 5 percent of the principal and accrued interest outstanding on the transaction for the purpose of the limitation on investments in a single institution, issuer, or trust set forth in paragraph (a) of this section.

(k) A corporate credit union may invest in a mutual fund if the investments and investment transactions of the fund are legally permissible for corporate credit unions.

(l) A corporate credit union is prohibited from:

(1) Purchasing or selling a standby commitment, except as provided in § 701.21(i) of this Chapter;

(2) Buying or selling a futures contract, forward rate agreement, swap agreement, or option contract;

(3) Engaging in adjusted trading;

(4) Engaging in a short sale;

(5) Purchasing a stripped mortgage-backed security or residual interest in a CMO/REMIC;

(6) Purchasing a zero coupon security with a maturity date that is more than 5 years from the settlement date for purchase of the security, except for funds matched against primary capital;



(7) Making deposits in nonfederally insured state banks, trust companies, and mutual savings banks; and  
(8) Purchasing commercial mortgage-related securities.

(m) A corporate credit union's officials, senior management employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the corporate credit union. The prohibition contained in this subsection also applies to any employee not otherwise covered if the employee is directly involved in investments or deposits. All transactions not specifically prohibited by this paragraph must be conducted at arm's length and in the interest of the credit union.

#### **§ 704.6 Capital goals, objectives and strategies.**

(a) *General.* Corporate credit unions shall adopt formal, written goals (both long-term and short-term), objectives and strategies, including a budgetary process, for the building of capital.

(b) *Impact study.* Where a proposed new service or program, purchase or lease of a fixed asset, or investment in or loan to a CSO may have a material effect on a corporate credit union, the corporate credit union shall perform a cost/benefit analysis of the activity and a study of its impact on the earnings and capital position of the corporate credit union.

(c) *Monitoring.* Management will establish monitoring standards and procedures to periodically review and reassess the capital position of the corporate credit union and will document these reviews.

#### **§ 704.7 Corporate service organizations (CSOs).**

(a) The aggregate of all investments in and loans to member and non member CSOs shall not exceed 15 percent of a corporate credit union's capital at the time the investment or loan is made. A corporate credit union may not use this authority to acquire control, directly or indirectly, of another financial institution, or to invest in shares, stocks or obligation of another financial institution, insurance company, trade association, liquidity facility, or similar organization. A CSO must be operated as an entity separate from any credit union. A corporate credit union investing in or lending to a CSO must take those steps necessary to ensure that it will not be held liable for the obligations of the CSO.

(b) An official or senior management employee of a corporate credit union which has invested in or loaned to a

CSO, and immediate family members of such an individual, may not receive, either directly or indirectly, any salary, commission, investment income, or other income or compensation, from the CSO. This prohibition extends to any other corporate credit union employee if such employee deals directly with the CSO.

(c) Prior to making an investment in or loan to a CSO, a corporate credit union must obtain a written agreement that the CSO will:

- (1) Follow GAAP;
- (2) Provide financial statements to the corporate credit union at least quarterly;
- (3) Obtain an annual CPA audit and provide a copy to the corporate credit union; and
- (4) Allow the auditor, supervisory committee, and NCUA complete access to its books, records, and any other pertinent documentation.

(d) A corporate credit union with an investment in, or a loan to, a credit union service organization (CUSO) as defined in § 701.27 of this chapter must, by January 1, 1996, divest of the investment, terminate the loan if contractually possible, or ensure that the organization meets the requirements of this section and § 704.2. If the loan cannot legally be terminated by January 1, 1996 it cannot be renewed or extended upon its next renewal or extension date.

#### **§ 704.8 Lending.**

(a) *Policies.* A corporate credit union shall develop, implement, and adhere to written loan policies which address, at a minimum:

- (1) Loan types and limits;
- (2) Documentation for each loan and line of credit;
- (3) Security;
- (4) Analysis of financial and operational data;
- (5) Monitoring standards; and
- (6) Review and reassessment of the credit quality of the member credit union.

(b) *General.* Each loan or line of credit limit will be determined after analyzing the financial and operational soundness of the member credit union and the ability of the member credit union to repay the loan. Loans are limited as follows:

(1) *Loans to member credit unions.* The maximum aggregated amount in loans and approved lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF and repurchase transactions, shall not exceed the corporate credit union's primary capital.

(2) *Loans to CSOs.* A corporate credit union may make loans and issue lines

of credit to CSOs, as defined in § 704.2 and subject to the limitations of § 704.7

(3) *Participation loans with other corporate credit unions.* A corporate credit union is permitted to participate in a loan with another corporate credit union and must retain an interest of at least 5 percent of the face amount of the loan. The participation agreement may be executed at any time prior to, during, or after disbursement. A participating corporate credit union must exercise the same due diligence as if it were the originating corporate credit union.

(4) *Prepayment penalties.* If provided for in the loan contract, a corporate credit union is authorized to assess prepayment penalties on loans made to member credit unions.

(5) *Prohibitions.* A corporate credit union may not make loans, issue lines of credit, or otherwise provide loan services to non members or natural person members. Except for providing overdraft protection for clearing accounts, a corporate credit union may not provide loan services to member trade associations. A loan or line of credit provided to a member trade association for the purpose of overdraft protection must be fully collateralized by any security which is permissible under § 704.5.

#### **§ 704.9 Borrowing.**

A corporate credit union may borrow up to 10 times capital or 50 percent of shares (excluding shares created by the use of member reverse repurchase agreements) and capital, whichever is less. Other than the issuance of the minimum amount of commercial paper to maintain a market presence, a corporate credit union may borrow only to meet liquidity needs. The need must be documented in writing and provided upon request to the auditor, supervisory committee, and NCUA. CLF borrowings, as agent member for natural person credit unions, and borrowed funds created by the use of repurchase agreements are excluded from this limit. In the event of extreme liquidity demands from its member credit unions, a corporate credit union may submit a request to NCUA for additional borrowing authority.

#### **§ 704.10 Services.**

A corporate credit union may provide services only to its members, subject to the limitations of this Part. A corporate credit union may not provide services to non members through the correspondent credit union authority or pursuant to § 701.26 of this chapter.

**§ 704.11 Fixed assets.**

(a) *General.* A corporate credit union's ownership in fixed assets shall be limited as described in § 701.36 of this chapter, except that in lieu of § 701.36 (c)(1) through (4), paragraph (b) of this section applies.

(b) *Investment in fixed assets.* (1) A corporate credit union may, invest in fixed assets where the aggregate of all such investments does not exceed 15 percent of primary capital.

(2) A corporate credit union shall submit requests to exceed the limitation of paragraph (b)(1) of this section to NCUA. Requests shall be supplemented by such statements and reports as NCUA may require. If NCUA determines that the proposal will not adversely affect the corporate credit union, it will respond in writing and an aggregate dollar amount or percentage of primary capital will be approved for investment in fixed assets.

**§ 704.12 Corporate Credit Union Reserves.**

(a) *Minimum Primary Capital Ratio.* The primary capital ratio is computed by dividing primary capital by average daily assets for the month. Each corporate credit union shall maintain a minimum primary capital ratio as follows:

(1) By January 1, 1996, primary capital shall be at least 2.5 percent of average daily assets. If this level of primary capital is not achieved, the corporate must submit a request for a waiver of this requirement to NCUA. The waiver request must provide an acceptable plan for meeting the requirement. This waiver request must be submitted to NCUA no later than 90 days prior to the effective date of this requirement.

(2) By January 1, 1997, primary capital shall be at least 3.0 percent of average daily assets. If this level of primary capital is not achieved, the corporate must submit a request for a waiver of this requirement to NCUA. The waiver request must provide an acceptable plan for meeting the requirement. This waiver request must be submitted to NCUA no later than 90 days prior to the effective date of this requirement.

(3) By January 1, 1998, primary capital must be at least 4.0 percent of average daily assets. Thereafter, each corporate credit union will be required to maintain a minimum primary capital to average daily assets ratio of 4.0 percent. Any corporate credit union that does not meet this provision will be considered to be inadequately capitalized and must submit to NCUA a plan of action to achieve this capital level within an acceptable period of

time. This plan must be submitted to NCUA within 30 calendar days of the month-end in which minimum primary capital fell below 4.0 percent.

(b) *Capital to risk-weighted assets ratio.* The capital to risk-weighted assets ratio is computed by dividing capital by total risk-weighted assets at month end. Each corporate credit union shall maintain capital of at least 10.0 percent of risk-weighted assets. Any corporate credit union that does not meet this provision will be considered to be inadequately capitalized and must submit to NCUA a plan of action to achieve this capital level within an acceptable period of time. This plan must be submitted to NCUA within 30 calendar days of the month-end in which capital fell below 10.0 percent of risk-weighted assets.

(c) *Failure to comply with minimum capital requirements.* NCUA will review each plan of action to achieve stated levels of capital as put forth in paragraphs (a) and (b) of this section. NCUA will make a determination as to the viability of the plan of action, and analyze the impact of the capital level on the corporate credit union and its member credit unions. If it is determined that a plan of action is not viable, the corporate credit union's board of directors will be required to merge or accept other corrective action as set forth by NCUA.

(d) *Procedures.* Balance sheet assets and credit equivalent amounts for off-balance sheet items are assigned to a risk-weight category. The total dollar amount in each category shall be multiplied by the risk-weight assigned to that category. The sum of the categories comprises risk-weighted assets.

(e) *Frequency.* Each corporate credit union shall calculate and document the ratio of primary capital to average daily assets and capital to risk-weighted assets each month. Documentation of such calculations shall be maintained and provided upon request to the auditor, supervisory committee, and NCUA.

(f) *Risk weights for balance sheet assets.* Each balance sheet asset shall be assigned a risk weight of 0 percent, 20 percent, 50 percent, and 100 percent as indicated in Appendix A of this part.

(g) *Other considerations.* (1) An investment in the shares of a mutual fund is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold.

(2) Accruals will be assigned the risk-weighting of the underlying asset that they represent.

(h) *Credit conversion factors for off-balance sheet items.* Off-balance sheet

items will be risk-weighted each month using credit conversion factors as indicated in Appendix B of this part.

(i) *Interim reserve accumulation.* Corporate credit unions will be required to accumulate sufficient amounts of primary capital to meet the requirements of paragraph (a) of this section. Each corporate credit union must prepare a written projection, including assumptions utilized, which shows compliance with the minimum primary capital requirements each year through the accumulation of net income and reserve transfers, the issuance of PCSAs, and/or the shrinkage of the corporate credit union's assets. The written projection must be provided upon request to the auditor, supervisory committee, and NCUA. In addition, each corporate credit union must meet the reserve transfer requirements outlined in paragraph (j) of this section.

(j) *Required reserve transfers.* The amount that a corporate credit union is required to transfer or set aside in reserves is based on both the corporate credit union's primary capital and capital to risk-weighted assets ratios. For the purposes of calculating required reserve transfers, PCSAs shall be excluded from primary capital. Ranges of capital ratios have been established. These capital ratio ranges are then associated with 1 of 5 corresponding categories in determining the required reserve transfer. To qualify for a lower reserve transfer category, the capital ratio must fall in both the primary capital and capital to risk-weighted assets ratio ranges of the applicable category. The corporate credit union shall set aside an amount equal to the appropriate required reserve transfer percentage multiplied by the corporate credit union's average daily assets for the transfer period multiplied by the number of days in the transfer period divided by 365.

(1) Category 1 requires a corporate reserve transfer percentage of 20 basis points of average daily assets when either the primary capital ratio is greater than 4.0 percent and less than 4.75 percent or the capital to risk-weighted assets ratio is greater than 10.0 percent and less than 11.0 percent.

(2) Category 2 requires a corporate reserve transfer percentage of 15 basis points of average daily assets when either the primary capital ratio is greater than 4.75 percent and less than 5.25 percent or the capital to risk-weighted assets ratio is greater than 11.0 percent and less than 14.0 percent.

(3) Category 3 requires a corporate reserve transfer percentage of 10 basis points of average daily assets when either the primary capital ratio is greater

than 5.25 percent and less than 5.75 percent or the capital to risk-weighted assets ratio is greater than 14.0 percent and less than 17.0 percent.

(4) Category 4 requires a corporate reserve transfer percentage of 5 basis points of average daily assets when either the primary capital ratio is greater than 5.75 percent and less than 6.0 percent or the capital to risk-weighted assets ratio percentage is greater than 17.0 percent and less than 20.0 percent.

(5) Category 5 requires a corporate reserve transfer percentage of 0 basis points when the primary capital ratio is greater than 6.0 percent and the capital to risk-weighted assets ratio percentage is greater than 20.0 percent.

(k) *Full and fair disclosure.* Corporate credit unions must provide reserves necessary for full and fair disclosure as specified in § 702.3 of this chapter.

#### § 704.13 Representation.

(a) *Board representation.* The board shall be determined as stipulated in the standard corporate federal credit union bylaws governing election procedures, provided that:

(1) The chair of the board may not serve simultaneously as an officer, director, or employee of a credit union trade association;

(2) A majority of directors may not serve simultaneously as officers, directors, or employees of the same credit union trade association or its affiliates (not including chapters or other subunits of a state trade association); and

(3) For purposes of meeting the requirements of paragraphs (a)(2) and (a)(3) of this section, an individual may not serve as a director or chair of the board if that individual holds a subordinate employment relationship to another employee who serves as an officer, director, or employee of a credit union trade association.

(b) *Representatives of member credit unions.* (1) A member credit union may appoint one of its members or officials as a representative to the corporate credit union. The representative shall be empowered to attend membership meetings, to vote, and to stand for election on behalf of the member. Only a member credit union representative is eligible to vote and to stand for election. No individual may serve as the representative of more than one member credit union in the same corporate credit union.

(2) Any vacancy on the board of a corporate credit union caused by a representative being unable to complete his or her term shall be filled by the board of the corporate credit union

according to its bylaws governing the filling of board vacancies.

(c) *Recusal provision.* (1) No director, committee member, officer, or employee of a corporate credit union shall in any manner, directly or indirectly, participate in the deliberation upon or the determination of any question affecting his or her pecuniary interest or the pecuniary interest of any entity (other than the corporate credit union) in which he or she is interested, except if the matter involves general policy applicable to all members, such as setting dividend or loan rates or fees for services.

(2) An individual is "interested" in an entity if he or she:

(i) Serves as a director, officer, or employee of the entity;

(ii) Has a business, ownership, or deposit relationship with the entity; or

(iii) Has a business, financial, or familial relationship with an individual whom he or she knows has a pecuniary interest in the entity.

(3) In the event of the disqualification of any directors, by operation of paragraph (c)(1) of this section, the remaining qualified directors present at the meeting, if constituting a quorum with the disqualified directors, may exercise, by majority vote, all the powers of the board with respect to the matter under consideration. Where all of the directors are disqualified, the matter must be decided by the members of the corporate credit union.

(4) In the event of the disqualification of any committee member by operation of paragraph (c)(1) of this section, the remaining qualified committee members, if constituting a quorum with the disqualified committee members, may exercise, by majority vote, all the powers of the committee with respect to the matter under consideration. Where all of the committee members are disqualified, the matter shall be decided by the board of directors.

(d) *Administration.* (1) A corporate credit union shall be under the direction and control of its board of directors. While the board may delegate the performance of administrative duties, the board is not relieved of its responsibility for their performance. The board may employ a chief executive officer who shall have such authority and such powers as delegated by the board to conduct business from day to day. Such chief executive officer must answer solely to the board of the corporate credit union, and may not be an employee of a credit union trade association.

(2) The provisions of § 701.14 of this chapter apply to corporate credit unions, except that where reference is

made to "Regional Director," substitute "NCUA."

#### § 704.14 Audit requirements.

(a) *Annual audit.* (1) The corporate credit union supervisory committee shall cause an annual opinion audit, which shall include a reportable conditions letter (i.e. management letter) to be made by an independent, duly licensed certified public account (CPA) and shall submit the audit report to the board of directors. A summary of the audit report shall be submitted to the membership at the next annual meeting.

(2) The CPA's audit workpapers shall be provided upon request to NCUA.

(3) A copy of the audit report and reportable conditions letter (i.e. management letter) shall be submitted to NCUA, within 30 days after receipt by the board of directors.

(b) *Internal auditor function.* (1) A corporate credit union with net assets in excess of \$100 million as of the preceding December 31, or as ordered by NCUA, will be required to employ or contract the services of an internal auditor.

(2) The internal auditor will report directly to the chairperson of the corporate credit union's supervisory committee.

(3) The internal auditor's responsibilities will include, but are not limited to, the review of ongoing compliance with statutory and regulatory requirements, adherence to the corporate credit union's own policies and procedures, testing of the accuracy and completeness of recordkeeping and operation functions, ensuring adequate control measures are in place, apprising the supervisory committee of all findings, and providing appropriate recommendations to address concerns and deficiencies relating to the condition or operations of the corporate credit union.

(4) The internal auditor's reports, findings, and recommendations will be in writing. Oral presentations by the internal auditor to the supervisory committee will be documented in the supervisory committee minutes. All documentation relating to the work of the internal auditor will be provided upon request to the external auditor and NCUA.

#### § 704.15 Contracts/written agreements.

Services, facilities, personnel, or equipment shared with any party shall be supported by a written contract, with the duties and responsibilities of each party specified and the allocation of service fee/expenses fully supported and documented.

**§ 704.16 State-chartered corporate credit unions.**

(a) This part does not expand the powers and authorities of any state-chartered corporate credit union, beyond those powers and authorities provided under the laws of the state in which it was chartered.

(b) A state-chartered corporate credit union that is not insured by the National Credit Union Share Insurance Fund, but that receives funds from federally insured credit unions, is considered an "institution-affiliated party" within the meaning of Section 206(r) of the Federal Credit Union Act, 12 U.S.C. 1786(r).

**§ 704.17 Fidelity bond coverage.**

(a) *Scope.* This section provides the fidelity bond requirements for employees and officials in corporate credit unions.

(b) *Review of coverage.* The board of directors of each corporate credit union shall, at least annually, carefully review the bond coverage in force to determine its adequacy in relation to risk exposure and to the minimum requirements in this section.

(c) *Minimum coverage; Approved forms.* Every corporate credit union will maintain bond coverage with a company holding a certificate of authority from the Secretary of the Treasury. All bond forms, and any riders and endorsements which limit the coverage provided by approved bond forms, must receive the prior written approval of the NCUA Board. The Corporate Credit Union Discovery Bond (NCUA 100) and Standard Form 24 with Credit Union Bond Conversion Endorsement are approved for use by corporate credit unions. Credit Union Blanket Bond Form 581 and Form 23—Extended Form, may also be utilized by corporate credit unions. Fidelity bonds must provide coverage for the fraud and dishonesty of all employees, directors, officers, and supervisory and credit committee members. Notwithstanding the foregoing, all bonds must include a provision, in a form approved by the NCUA Board, requiring written notification by surety to the Board: When the bond of a credit union is terminated in its entirety; or when bond coverage is terminated, by issuance of a written notice, on an employees, director, officer, supervisory or credit committee member. Said notification shall be sent to the Secretary of the NCUA Board or designee and shall include a brief statement of cause for termination.

(d) *Minimum; coverage amounts.* (1) The minimum amount of bond coverage will be computed based on the

corporate credit union's average daily assets as of December 31 of the preceding year. The following table lists the minimum requirements:

Net assets	Minimum bond (million)
Less than \$50 million .....	\$1.0
\$50—\$99 million .....	2.0
\$100—\$499 million .....	4.0
\$500—\$999 million .....	6.0
\$1.0—\$1.999 billion .....	8.0
\$2.0—\$4.999 billion .....	10.0
\$5.0—\$9.999 billion .....	15.0
\$10—\$24.999 billion .....	20.0
\$25.0 billion plus .....	25.0

(2) It is the duty of the board of directors of each corporate credit union to provide adequate protection to meet its unique circumstances by obtaining, when necessary, bond coverage in excess of the above minimums.

(e) *Reduced coverage; NCUA approval.* Any proposal for reduced coverage must be approved in writing by the NCUA Board at least 20 days in advance of the proposed effective date of the reduction.

(f) *Deductibles.* (1) The maximum amount of deductibles allowed are based on the corporate credit union's primary capital ratio as defined in § 704.12(a). The following table sets out the maximum deductibles:

Primary capital ratio	Maximum deductible
Less than 4.0 percent.	7.5 percent of primary capital.
4.0—7.99 percent	10.0 percent of primary capital.
8.0—11.99 percent.	12.0 percent of primary capital.
Greater than 12.0 percent.	15.0 percent of primary capital.

(2) A deductible may be applied separately to one or more insuring clauses in a blanket bond. Deductibles in excess of those showing in this section must have the written approval of the NCUA Board at least 20 days prior to the effective date of the deductibles.

(g) *Additional coverage.* The NCUA Board may require additional coverage for any corporate credit union when, in the opinion of the Board, current coverage is insufficient. The board of directors of the corporate credit union must obtain additional coverage within 30 days after the date of written notice from the NCUA Board.

**§ 704.18 Effective date.**

The regulations in this part are effective beginning January 1, 1996.

**Appendix A to Part 704—Summary of Risk Weights and Risk Categories for Corporate Credit Unions**

Category 1: Zero Percent Risk Weight.

a. Coin and currency on hand or physically in transit.

b. Balances due from and claims on Federal Reserve Banks.

c. Claims on and portions of claims that are unconditionally guaranteed by the U.S. Government or its agencies.

d. Claims collateralized by cash or eligible deposits.

e. CLF subscriptions, including U.S. Central CLF Participation Certificates, and CLF Pass-Through Loans from the CLF through U.S. Central to the corporate credit unions.

f. Asset Accounts related to Member Reverse Repurchase Agreements without indemnity obligation.

g. Accrued Interest Receivable on the above.

Category 2: 20 Percent Risk Weight.

a. Items, other than coin and currency, in process of collection.

b. Claims on or portions of claims guaranteed by U.S. Government-sponsored corporations and enterprises.

c. Claims conditionally guaranteed by the U.S. Government or its agencies or U.S. Government-sponsored corporations and enterprises.

d. Claims or portions of claims (including Repurchase Agreements) collateralized by securities issued by the U.S. Government or its agencies or U.S. Government-sponsored corporations and enterprises.

e. General obligation claims on state and local governments located in the United States.

f. Claims on U.S. depository institutions (including Federal Funds sold)

g. Claims on a corporate credit union.

h. Asset accounts related to Member Reverse Repurchase Agreements with indemnity obligation.

i. Asset-backed securities with remaining weighted average lives of 3 years or less.

j. Secured loans to credit unions.

k. Accrued Interest Receivable on the above.

Category 3: 50 Percent Risk Weight.

a. Asset-backed securities with remaining weighted average lives greater than 3 years.

b. Privately-issued mortgage-backed securities provided that: (1) The security is structured so that it is treated as an indirect holding of the underlying assets;<sup>1</sup> (2) If the

<sup>1</sup> A private-issued mortgage-backed security may be treated as an indirect holding of the underlying assets provided that: (1) The underlying assets are held by an independent trustee and the trustee has a first priority, perfected security interest in the underlying assets on behalf of the holders of the security; (2) either the holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets or the trust or single purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities; (3) the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash flow requirements of the security without undue reliance on any reinvestment income; and (4) there is no material reinvestment risk associated with any funds awaiting distribution to the holders

security is backed by a pool of conventional mortgages, 1- to 4-family residential, or multifamily residential properties, each underlying mortgage must have been made in accordance with prudent underwriting standards, be performing in accordance with its original terms, and not be 90 days or more past due or carried in nonaccrual status; (3) If the security is backed by privately-issued mortgage-backed securities, each underlying security qualifies for the 50 percent risk category at the time the pool is originated; and (4) if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due.

c. Accrued Interest Receivable on the above.

d. Claims on foreign banks (including Fed Funds sold).

Category 4: 100 Percent Risk Weight for All Other Assets Including, but NOT LIMITED to:

a. Loans to CUSOs outstanding as of January 1, 1996.

b. Loans to and Investments in CSOs.

c. Unsecured loans to credit unions.

d. All fixed assets, including land, buildings, furniture, fixtures, equipment, automobiles, and leasehold improvements.

e. Permanent capital share account and secondary capital share account investments in a corporate credit union.

f. Any mortgage-backed securities that do not meet the criteria for assignment to a lower risk weight (including any classes of mortgage-backed securities that can absorb more than their pro rata share of loss without the whole issue being in default).

g. Zero Coupon Securities.

h. Claims on U.S. chartered corporations and bank holding companies, including commercial paper and corporate bonds.

i. Mutual Funds that do not qualify for a lower risk weighting.

j. Prepaid Assets.

k. Accounts Receivable and other receivables.

l. NCUSIF Deposit

m. Mortgage servicing rights.

n. Intangible assets.

o. All other claims on private obligors.

p. Accrued Interest Receivable on the above.

#### Appendix B to Part 704—Off-Balance Sheet Credit Conversion Factors

Zero Percent Credit Conversion Factor:  
Unused portions of credit lines with original maturities of 6 months or less, or which are unconditionally cancelable.

50 Percent Credit Conversion Factor:  
a. Unused portions of credit lines with original maturities exceeding 6 months.

of the security. In addition, if the underlying assets of a mortgage-backed security are composed of more than one type of asset, for example, U.S. Government-sponsored agency securities and privately-issued pass-through securities that qualify for the 50 percent risk category, the entire mortgage-backed security is generally assigned to the category appropriate to the highest risk-weighted asset underlying the issue. Thus, in this example, the security would receive the 50 percent risk weight appropriate to the privately-issued pass-through securities.

b. Commitments to participate in a loan or loan package.

100 Percent Credit Conversion Factor:

a. Irrevocable standby letters of credit guaranteeing financial performance (including VISA letters of credit issued by corporate credit unions on behalf of their members, or standby letters of credit backing Industrial Revenue Bonds).

b. Forward Commitments to purchase an asset or perform under a lease contract.

c. Securities held in safekeeping loaned with indemnification. Other off-balance sheet items will be addressed on a case-by-case basis by NCUA.

#### Appendix C to Part 704—Model Forms

This appendix contains three sample forms intended for use by corporate credit unions to aid in compliance with the permanent capital share account and secondary capital share account disclosure requirements of § 704.2. Corporate credit unions that use these forms will be in compliance with those requirements.

C-1 Sample disclosure for opening of secondary capital share account.

Terms and Conditions of Secondary Capital Share Account

(1) A secondary capital share account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A member credit union may withdraw shares from its secondary capital share account only with two years' notice, except where the member credit union is merging or liquidating. If a member credit union merges, the corporate credit union will return the member's secondary capital shares, less any penalty for early withdrawal, within 30 days of written notification from NCUA.

(3) Secondary capital share accounts cannot be used by member credit unions to collateralize borrowings.

(4) Secondary capital share accounts are available to absorb losses in the event of a deficit in primary capital in the corporate credit union.

(5) Where the corporate credit union is liquidated, secondary capital share accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the secondary capital share account.

Signatures of Directors and Date

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Name of member credit union:

Address of member credit union:

\_\_\_\_\_  
\_\_\_\_\_

C-2 Sample annual notice of terms and conditions of secondary capital share account.

Terms and Conditions of Secondary Capital Share Account

(1) A secondary capital share account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A member credit union may withdraw shares from its secondary capital share account only with two years' notice, except where the member credit union is merging or liquidating. If a member credit union merges, the corporate credit union will return the member's secondary capital shares, less any penalty for early withdrawal, within 30 days of written notification from NCUA.

(3) Secondary capital shares cannot be used by member credit unions to collateralize borrowings.

(4) Secondary capital share accounts are available to absorb losses in the event of a deficit in primary capital in the corporate credit union.

(5) Where the corporate credit union is liquidated, secondary capital share accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

Mailed to member

\_\_\_\_\_  
Month/Year.

Signature of the Chairman of the Board

C-3 Sample disclosure for opening of permanent capital share account.

Terms and Conditions of Permanent Capital Share Account

(1) A permanent capital share account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) Permanent capital shares are not redeemable without the written concurrence of NCUA.

(3) Permanent capital share accounts cannot be used by member credit unions to collateralize borrowings.

(4) Permanent capital share accounts are available to absorb losses in the event of a deficit in other primary capital accounts in the corporate credit union.

(5) Where the corporate credit union is liquidated, permanent capital share accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

(6) Permanent capital share account dividends are noncumulative.

I have read the above terms and conditions and I understand them.

Signatures of Directors and Date

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Name of member credit union:

Address of member credit union:

\_\_\_\_\_  
\_\_\_\_\_

#### PART 741—REQUIREMENTS FOR INSURANCE

2. The authority citation for part 741 continues to read as follows:

**Authority:** 12 U.S.C. 1757, 1766, and 1781–1790. Section 741.11 is also authorized by 31 U.S.C. 3717.

3. Section 741.3 is amended by revising the heading and adding new paragraph (c) to read as follows:

**§ 741.3 Other requirements.**

\* \* \* \* \*

(c) Adhere to the requirements stated in Part 703 of this chapter concerning transacting business with corporate credit unions.

[FR Doc. 95–10149 Filed 4–25–95; 8:45 am]

BILLING CODE 7535–01–P

## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 39

[Docket No. 94–NM–110–AD]

#### Airworthiness Directives; British Aerospace Model Viscount 744, 745D, and 810 Airplanes

**AGENCY:** Federal Aviation Administration, DOT.

**ACTION:** Notice of proposed rulemaking (NPRM).

**SUMMARY:** This document proposes the adoption of a new airworthiness directive (AD) that is applicable to all British Aerospace Model Viscount 744, 745D, and 810 series airplanes. This proposal would require repetitive inspections to detect discrepancies of certain fittings and the actuator beam structure of the nose landing gear, and replacement of discrepant parts. This proposal is prompted by reports of fatigue cracking of the undercarriage bracing of the nose wheel. The actions specified by the proposed AD are intended to prevent such fatigue cracking, which could result in the failure of the structure and fittings, and subsequent collapse of the nose landing gear.

**DATES:** Comments must be received by May 5, 1995.

**ADDRESSES:** Submit comments in triplicate to the Federal Aviation Administration (FAA), Transport Airplane Directorate, ANM–103, Attention: Rules Docket No. 94–NM–110–AD, 1601 Lind Avenue, SW., Renton, Washington 98055–4056. Comments may be inspected at this location between 9:00 a.m. and 3:00 p.m., Monday through Friday, except Federal holidays.

The service information referenced in the proposed rule may be obtained from British Aerospace Regional Aircraft Ltd.,

Engineering Support Manager, Military Business Unit, Chadderton Works, Greengate, Middleton, Manchester M24 1SA, England. This information may be examined at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington.

**FOR FURTHER INFORMATION CONTACT:**

William Schroeder, Aerospace Engineer, Standardization Branch, ANM–113, FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington 98055–4056; telephone (206) 227–2148; fax (206) 227–1320.

**SUPPLEMENTARY INFORMATION:**

#### Comments Invited

Interested persons are invited to participate in the making of the proposed rule by submitting such written data, views, or arguments as they may desire. Communications shall identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments, specified above, will be considered before taking action on the proposed rule. The proposals contained in this notice may be changed in light of the comments received.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposed rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report summarizing each FAA-public contact concerned with the substance of this proposal will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this notice must submit a self-addressed, stamped postcard on which the following statement is made: “Comments to Docket Number 94–NM–110–AD.” The postcard will be date stamped and returned to the commenter.

#### Availability of NPRMs

Any person may obtain a copy of this NPRM by submitting a request to the FAA, Transport Airplane Directorate, ANM–103, Attention: Rules Docket No. 94–NM–110–AD, 1601 Lind Avenue, SW., Renton, Washington 98055–4056.

#### Discussion

The Civil Aviation Authority (CAA), which is the airworthiness authority for the United Kingdom, recently notified the FAA that an unsafe condition may exist on all British Aerospace Model Viscount 744, 745D, and 810 airplanes.

The CAA advises that reports have been received of cracking in the bracing structures of the nose wheel undercarriage on these airplanes. Investigation revealed that the cracking was fatigue related, and that deterioration of the structure also has occurred. These conditions, if not detected and corrected in a timely manner, could result in the collapse of the nose landing gear.

British Aerospace has issued Viscount Alert Preliminary Technical Leaflet (PTL) 331, VIS 1 Doc 12 (for Model 744 and 745D airplanes), and PTL 202, VIS 1 Doc. 4 (for Model 810 airplanes), both dated November 1, 1991. These PTL's describe the following procedures:

1. Procedures for repetitive non-destructive testing (NDT) inspections to detect cracking of the actuator attachment fittings of the nose landing gear.

2. Procedures for repetitive visual inspections to detect signs of structural deterioration of the central diaphragms of the actuator beam structure.

3. Procedures to detect elongation, cracking, buckling in the central diaphragms and reinforcing angles, and loosening of fasteners of the mounting bolt holes of the actuator attachment. And

4. Procedures for replacement of deteriorated or cracked parts with new parts. The CAA classified these alert PTL's as mandatory in order to assure the continued airworthiness of these airplanes in the United Kingdom.

This airplane model is manufactured in the United Kingdom and is type certificated for operation in the United States under the provisions of § 21.29 of the Federal Aviation Regulations (14 CFR 21.29) and the applicable bilateral airworthiness agreement. Pursuant to this bilateral airworthiness agreement, the CAA has kept the FAA informed of the situation described above. The FAA has examined the findings of the CAA, reviewed all available information, and determined that AD action is necessary for products of this type design that are certificated for operation in the United States.

Since an unsafe condition has been identified that is likely to exist or develop on other airplanes of the same type design registered in the United States, the proposed AD would require repetitive inspections to detect discrepancies of certain fittings and the actuator beam structure of the nose landing gear, and replacement of discrepant parts. The actions would be required to be accomplished in accordance with the alert PTL's described previously.